# Explanatory Notes Relating to Income Tax

Published by
The Honourable Paul Martin, P.C., M.P.
Minister of Finance

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# PREFACE

These explanatory notes describe proposed amendments to the *Income Tax Act*, the *Canada Pension Plan*, the *Customs Act*, the *Excise Tax Act* and related Acts. Draft amendments to the Income Tax Regulations, with corresponding explanatory notes, are also included. These explanatory notes describe these amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable Paul Martin
Minister of Finance

These explanatory notes are provided to assist in an understanding of proposed amendments to the *Income Tax Act*, the *Canada Pension Plan*, the *Customs Act*, the *Excise Tax Act* and related Acts. Draft amendments to the Income Tax Regulations, with corresponding explanatory notes are also included. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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## Clause 2

### Employee Stock Options

ITA
7

Section 7 of the *Income Tax Act* deals with agreements (commonly referred to as stock options) under which employees of a corporation or mutual fund trust acquire rights to acquire securities of the employer (or a person with whom the employer does not deal at arm's length).

### Agreement to Issue Securities to Employees

ITA
7(1)

Under subsection 7(1) of the Act, an employee who acquires a security under an employee option agreement is deemed to have received, in the year the security is acquired, a benefit from employment equal to the excess of the fair market value of the security over the amount paid by the employee to acquire the security. Subsection 7(1) is subject to subsection 7(1.1) of the Act. Subsection 7(1.1) provides that, where the security is acquired under an option granted to an arm's length employee by a Canadian-controlled private corporation (CCPC), subsection 7(1) is to be read so as to deem the employment benefit to have been received in the year the employee disposes of the security, rather than in the year the employee acquires the security.

Subsection 7(1) is amended so that it is also subject to new subsection 7(8). Subsection 7(8) provides that, where an employee acquires a security after February 27, 2000 under an option granted by a corporation (other than a CCPC) or by a mutual fund trust, subsection 7(1) is to be read so as to deem the employment benefit to have been received in the year the employee disposes of the security. In order for subsection 7(8) to apply, the acquisition must be a qualifying acquisition as described in new subsection 7(9), and the employee must elect to defer recognition of the benefit in accordance with new subsection 7(10). (See the commentary on those subsections for further details.)

It should be noted that amended subsection 7(1.3) of the Act provides rules for determining the order of the disposition of identical properties. In effect, securities for which a deferral is provided under subsection 7(1.1) or (8) are considered to be disposed of only after identical securities for which no deferral is provided and, then, in the order in which the employee acquired them. New subsection 47(3) of the Act provides that securities that are acquired after February 27, 2000, and for which a deferral is provided under subsection 7(1.1) or (8), are deemed, for the purpose of the cost-averaging rule in subsection 47(1), not to be identical to any other securities owned by the taxpayer. Consequently, each of the deferral securities will have its own unique adjusted cost base (ACB). Finally, it should be noted that, under amended paragraph 53(1)(*j*) of the Act, the ACB of a security that is acquired after February 27, 2000, and for which a deferral is provided under subsection 7(1.1) or (8), is determined as though the employment benefit were recognized, for tax purposes, at the time the security is acquired. (See the commentary on those provisions for further details.)

The amendment to subsection 7(1) applies to the 2000 and subsequent taxation years.

## Order of Disposition of Securities

ITA
7(1.3)

Subsection 7(1.3) of the Act provides, for the purposes of subsection 7(1.1), a rule for determining the order in which a taxpayer disposes of shares that are identical properties. The rule is relevant in that subsection 7(1.1) defers recognition, for tax purposes, of the employment benefit arising from an employee's acquisition of a share under an option granted by a Canadian-controlled private corporation (CCPC) until the employee disposes of the share. The rule deems the employee to dispose of identical shares in the order in which the employee acquired them – that is, on a first-in-first-out basis.

Subsection 7(1.3) is amended in a number of ways. First, it is amended so that it also applies for the purposes of new subsection

7(8), paragraph 110(1)(*d*.01) and subsection 110(2.1) of the Act and for the purposes of existing subdivision c, subparagraph 110(1)(*d*.1)(ii) and subsection 147(10.4) of the Act.

- Subsection 7(8) is similar to existing subsection 7(1.1) in that it defers recognition, for tax purposes, of the employment benefit arising from a taxpayer's acquisition of certain employee option securities until the securities are disposed of. Subsection 7(8) applies to publicly-listed shares, and mutual fund trust units, acquired after February 27, 2000. Extending the application of subsection 7(1.3) to subsection 7(8) ensures that it is possible to determine when a particular security for which a deferral has been provided under subsection 7(8) has been disposed of and, consequently, when the employment benefit that is associated with the taxpayer's acquisition of the security is to be recognized for tax purposes.

- Paragraph 110(1)(*d*.01) allows a taxpayer to deduct a portion of the employment benefit that the taxpayer is deemed by subsection 7(1) to have received in respect of the acquisition of a qualifying employee option security, if the taxpayer disposes of the security by donating it to a qualifying charity within a certain period of time. Similarly, subsection 110(2.1) allows such a deduction if, instead of donating the security, the taxpayer immediately disposes of the security and donates all or part of the proceeds of disposition to a qualifying charity. Extending the application of subsection 7(1.3) to these provisions ensures that, in those cases where the taxpayer holds identical securities and new subsection 7(1.31) does not apply, a determination can be made as to which security is being disposed of and, consequently, whether or not the conditions for the deduction have been satisfied.

- Subdivision c sets out rules for determining taxable capital gains and allowable capital losses when a taxpayer disposes of capital property. Extending the application of subsection 7(1.3) to subdivision c ensures that, when a taxpayer disposes of a security that is identical to other securities owned by the taxpayer, the security that the taxpayer is considered to have disposed of for purposes of the employee security option rules in section 7 is also the security that the taxpayer is considered to have disposed of for purposes of the capital gains rules.

- Paragraph 110(1)(*d*.1) allows a taxpayer to deduct a portion of the employment benefit that the taxpayer is deemed, by subsection 7(1) of the Act, to have received when disposing of a share acquired under an employee option granted by a CCPC. Subparagraph 110(1)(*d*.1)(ii) requires that, in order to qualify for the deduction, the taxpayer must not dispose of the share within two years of acquiring it. Extending the application of subsection 7(1.3) to subparagraph 110(1)(*d*.1)(ii) ensures that, in those cases where the taxpayer holds identical shares, a determination can be made as to when a particular security that was acquired under a CCPC option is disposed of and, consequently, whether or not the taxpayer has satisfied the two-year hold requirement.

- Subsection 147(10.4) provides that, where a taxpayer disposes of shares which the taxpayer received as part of a lump sum payment on withdrawing from a deferred profit sharing plan (DPSP) and in respect of which the taxpayer filed an election under subsection 147(10.1) of the Act, the taxpayer is to include in income, in the year of disposition, an amount equal to the excess of the fair market value of the shares when they were withdrawn over the cost amount of the shares to the DPSP. The application of subsection 7(1.3) to subsection 147(10.4) is consequential to the repeal of subsection 147(10.5) of the Act, which contains an ordering rule for subsection 147(10.4) that is identical to the rule in existing subsection 7(1.3).

Second, subsection 7(1.3) is amended to provide two rules for determining, for the purpose of that subsection, the order in which identical securities are considered to have been acquired.

- Paragraph 7(1.3)(*a*) provides that, where a taxpayer who holds securities that were acquired under circumstances to which any of subsections 7(1.1) or (8) or subsection 147(10.1) applied (referred to in these notes as "deferral securities") acquires identical securities that are not deferral securities, the new securities are deemed to have been acquired immediately before the earliest acquisition of the deferral securities. The effect of this deeming rule, in conjunction with the ordering rule for dispositions, is that a taxpayer holding both deferral and non-deferral securities is considered to dispose of the non-deferral securities first.

- Paragraph 7(1.3)(*b*) provides that, when a taxpayer acquires a number of identical deferral securities at one time, the securities are deemed to have been acquired in the order in which the options under which the securities are acquired were granted. The effect of this deeming rule, in conjunction with the ordering rule for dispositions, is that a taxpayer who acquires identical securities under different options at the same time is considered to dispose of those securities in the order in which the relevant options were granted.

Third, subsection 7(1.3) is amended so that it is subject to new subsection 7(1.31) and paragraph 7(14)(*c*) of the Act.

- New subsection 7(1.31) contains a special rule allowing a taxpayer who disposes of a security that is identical to other securities owned by the taxpayer to designate the most recently acquired security as the security being disposed of, provided certain conditions are met.

- New subsection 7(14) allows the Minister of National Revenue to treat an invalid deferral of an employment benefit arising from a taxpayer's acquisition of an employee option security as a valid deferral under new subsection 7(8) of the Act by sending a written notice to this effect to the taxpayer. If the taxpayer has not disposed of the security before the time the notice is sent, paragraph 7(14)(*c*) deems the taxpayer to have disposed of it at that time for the purposes of section 7. This ensures that the employment benefit is recognized and taxed at that time. Paragraph 7(14)(*c*) also deems the taxpayer to have reacquired the security immediately after that time, but not under an employee option agreement. Thus, from that point on, the security is treated, for the purposes of the ordering rule in subsection 7(1.3), as a non-deferral security.

It should be noted that new subsection 47(3) of the Act provides that securities that are acquired after February 27, 2000, and for which a deferral is provided under subsection 7(1.1) or (8) or 147(10.1), are deemed, for the purpose of the cost-averaging rule in subsection 47(1), not to be identical to any other securities owned by the taxpayer. Consequently, the adjusted cost base (ACB) of each such security, and thus the capital gain or loss on the disposition of the security, is determined without regard to the ACB of any other securities owned by the taxpayer. (See the commentary on new subsection 47(3), and the examples provided as part of that commentary, for further details.)

Amended subsection 7(1.3) applies to securities acquired after February 27, 2000. It also applies to securities acquired, but not disposed of, before February 28, 2000.

## Disposition of Newly-Acquired Securities

ITA
7(1.31)

New subsection 7(1.31) of the Act contains a special provision which applies when a taxpayer disposes of a security that is identical to other securities owned by the taxpayer. The provision deems a particular security, as designated by the taxpayer, to be the security that is the subject of the disposition. In order for this subsection to apply, certain conditions must be met.

First, the particular security must have been acquired under an employee option agreement, as described in subsection 7(1) of the Act.

Second, the disposition must occur no later than 30 days after the taxpayer acquires the particular security.

Third, there must be no other acquisitions or dispositions of identical securities in the intervening period; that is, after the acquisition of the particular security and before the disposition in respect of which the designation is being made. It should be noted, however, that this does not preclude the taxpayer from acquiring other identical securities at the same time as the particular security is acquired, or from disposing of other identical securities at the same time as the disposition in respect of which the designation is being made.

Fourth, the taxpayer must make the designation in the return of income that is filed for the year in which the disposition occurs. It is expected that the Minister of National Revenue will accept, as the form of designation, the calculation of the capital gain or loss in respect of the disposition on the basis that it is the particular security that is the subject of the disposition.

Finally, the taxpayer must not have designated the particular security in connection with the disposition of any other security.

***Example***

*On May 1, 2000, Joseph acquires 750 shares of his corporate employer on the open market. On May 1, 2001, he acquires another 750 shares on the open market. On May 1, 2002, he acquires an additional 1,000 shares under employee stock options. Immediately thereafter, he sells 1,500 shares. In his return of income for 2002, he designates the 1,000 stock option shares as constituting part of the shares that were sold. Pursuant to subsections 7(1.3) and (1.31), the 1,500 shares being sold by Joseph are deemed to be comprised of the 1,000 stock option shares and 500 of the 750 shares that Joseph acquired on the open market on May 1, 2000.*

It should be noted that the provisions of subsection 7(1.31) accommodate the practice of specific identification that was adopted by the Canada Customs and Revenue Agency (CCRA). (See CCRA's Income Tax Technical News No. 19, dated June 16, 2000, for further details.) The significance of subsection 7(1.31) for the purpose of new paragraph 110(1)(*d*.01) should also be noted. That paragraph allows a taxpayer to deduct a portion of the employment benefit that the taxpayer is deemed by subsection 7(1) to have received in respect of the taxpayer's acquisition of a qualifying employee option security, if the taxpayer disposes of the security by donating it to a qualifying charity within 30 days after its acquisition.

It should also be noted that new subsection 47(3) of the Act provides that securities to which subsection 7(1.31) applies are deemed, for the purpose of the cost-averaging rule in subsection 47(1), not to be identical to any other securities owned by the taxpayer. Consequently, the adjusted cost base (ACB) of each such security, and thus the capital gain or loss on the disposition of the security, is determined without regard to the ACB of any other securities owned by the taxpayer. (See the commentary on new subsection 47(3), and the examples provided as part of that commentary, for further details.)

New subsection 7(1.31) applies to securities acquired after February 27, 2000. It also applies to securities acquired, but not disposed of, before February 28, 2000.

## Exchange of Options

ITA
7(1.4)

Subsection 7(1.4) of the Act contains provisions that apply when an individual disposes of rights to acquire securities under an employee option agreement in exchange for other such rights. Provided certain conditions are met, subsection 7(1.4) deems the disposition not to have occurred and deems the new option to be the same as, and a continuation, of the original option.

Subsection 7(1.4) is amended so that the terms "exchanged option" and "old securities", as referred to in paragraph 7(1.4)(*a*), no longer apply for the purpose of paragraph 110(1)(*d*). This amendment is consequential to changes to paragraph 110(1)(*d*), which no longer uses these terms. Paragraph 7(1.4)(*a*) is also amended to delete a redundant reference to subsection 7(1.1). These amendments apply to the 1998 and subsequent taxation years.

Subsection 7(1.4) is also amended so that paragraph 7(1.4)(*d*), which deems the disposition not to have occurred, does not apply for the purpose of new subparagraph 7(9)(*d*)(ii). This ensures that subparagraph 7(9)(*d*)(ii) – which requires that the options being disposed of in a qualifying exchange satisfy certain conditions in order for the new deferral provisions of subsection 7(8) to apply to the new options – is capable of application. This amendment applies to the 2000 and subsequent taxation years.

## Rules Where Securities Exchanged

ITA
7(1.5)

Subsection 7(1.5) of the Act contains a special rule that applies for the purposes of the rules in subsection 7(1.1) and paragraph 110(1)(*d*.1). Subsection 7(1.1) provides that, if an arm's length employee acquires a share under an option granted by a

Canadian-controlled private corporation (CCPC), recognition of the employment benefit for tax purposes is deferred until the employee disposes of the share. When the employee disposes of the share and is taxed on the employment benefit, paragraph 110(1)(*d*.1) allows the employee to deduct a portion of the benefit if the share has been held for at least two years.

Under subsection 7(1.5), a qualifying exchange of shares acquired under an option granted by a CCPC for other shares is deemed not to be a disposition for the purposes of subsection 7(1.1) and paragraph 110(1)(*d*.1), and the new shares are deemed to be a continuation of the old shares. Consequently, taxation of the employment benefit associated with the old shares is deferred until the employee disposes of the new shares, and the two-year hold requirement for the deduction is based on the combined amount of time that the old and new shares are held. To qualify, the exchange must be for shares of a corporation within the corporate group (including corporations formed on an amalgamation or merger), the employee must receive no consideration for the disposition of the old shares other than the new shares, and the value of the new shares must be no greater than the value of the old shares.

Subsection 7(1.5) is amended so that it also applies to exchanges of employee option securities acquired under circumstances to which new subsection 7(8) applies. Subsection 7(8), which applies to publicly-listed shares and mutual fund trust units acquired under employee option agreements after February 27, 2000, defers recognition of the employment benefit associated with the acquisition of the security until the security is disposed of, provided certain conditions are met. (See the commentary on subsection 7(8) for further details.) The extension of subsection 7(1.5) to these securities ensures that the deferral provided by subsection 7(8) does not cease if the security is exchanged for another qualifying security.

Subsection 7(1.5) is also amended so that it applies for purposes of new paragraph 110(1)(*d*.01) of the Act, which allows a special deduction in computing income when an employee donates an employee option security acquired after February 27, 2000 and before 2002 to a qualifying charity. The extension of subsection 7(1.5) to these circumstances ensures that the special deduction is not lost if the employee exchanges the option security for another qualifying security, in accordance with subsection 7(1.5), and donates the new security to charity.

Finally, subsection 7(1.5) is amended so that the rule in paragraph 7(1.5)(*e*) which deems the new securities to be the same securities as, and a continuation of, the old securities does not apply so as to deem the new securities to be identical to securities to which they would not otherwise be identical. This ensures that the rules in subsections 7(1.3) and (1.31) of the Act, which deem identical securities to be disposed of in a particular order, do not apply to identify a particular security as the security that is disposed unless the security is, in fact, identical to the security that is the subject of the disposition.

It should be noted that where a taxpayer acquires an employee option security after February 27, 2000, and the security is acquired under circumstances to which subsection 7(1.1) or (8) applied, the employment benefit that will be recognized only at the time of the disposition of the security is, nevertheless, added to the adjusted cost base of the security at the time the security is acquired pursuant to amended paragraph 53(1)(*j*) of the Act. Thus, if the security is exchanged for another security under circumstances to which subsection 7(1.5) applies but for which there is no rollover for capital gains purposes, the benefit is taken into account in determining the capital gain or loss on the disposition of the old security.

The amendments to subsection 7(1.5) apply to exchanges of securities that occur after February 27, 2000.

**Emigration**

ITA
7(1.6)

New subsection 7(1.6) of the Act applies where an individual emigrates from Canada while holding shares that were acquired under an employee stock option granted by a Canadian-controlled private corporation, and for which a deferral of taxation is provided under subsection 7(1.1) of the Act.

Although an individual holding shares to which subsection 7(1.1) applies is deemed, by subsection 128.1(4), to dispose of the shares on emigration, new subsection 7(1.6) deems the disposition not to have occurred for the purposes of section 7 and paragraph 110(1)(*d*.1) of the Act. As a result, emigration will not, by itself, trigger an income inclusion of the stock option benefit associated with the shares. However, since the emigrating individual is still treated as having disposed of the shares for all other purposes of the Act, any gain (or loss) accrued since the shares were acquired will be realized on emigration. (See the commentary on new paragraph 128.1(4)(*d*.1) for additional information on shares acquired before February 28, 2000.)

The provisions of subsection 7(1.6) do not apply to employee option securities (i.e., corporate shares or mutual fund trust units) in respect of which a deferral is provided under new subsection 7(8) of the Act. Accordingly, the deferral on these securities ceases at the time of emigration.

New subsection 7(1.6) applies after 1992.

## Rights Ceasing to be Exercisable

ITA
7(1.7)

New subsection 7(1.7) of the Act contains rules that apply when an individual's rights to acquire securities (i.e., corporate shares or mutual fund trusts units) under an employee option agreement cease to be exercisable in accordance with the terms of the agreement and the cessation is not otherwise considered to be a transfer or disposition of those rights by the individual.

Paragraph 7(1.7)(*a*) provides that, where an individual receives an amount in respect of such a cessation, the individual is deemed, for the purposes of paragraphs 7(1)(*b*) and 110(1)(*d*) of the Act, to have disposed of the rights under the employee option agreement at the time the amount is received and to have received the amount as consideration for the disposition. As a result, the individual is deemed by paragraph 7(1)(*b*) to have received an employment benefit equal to the amount so received less the amount, if any, paid by the individual to acquire those rights. In addition, if the conditions in paragraph 110(1)(*d*) are satisfied, the individual is entitled to deduct a portion of the benefit in computing taxable income.

Paragraph 7(1.7)(*b*) contains a rule for determining the amount that an individual is considered to have paid for rights that are the subject of a cessation to which paragraph 7(1.7)(*a*) applies. This is relevant in that (as noted above) this amount reduces the benefit that the individual is deemed by paragraph 7(1)(*b*) to have received as a consequence of the deemed disposition under paragraph 7(1.7)(*a*). Generally, this amount will be the actual amount paid by the individual to acquire the rights in question. However, if the individual has received amounts in respect of the cessation on more than one occasion, the amount that the individual is considered to have paid to acquire the rights in question in applying paragraph 7(1)(*b*) to each disposition after the initial deemed disposition will be reduced by the total of all the amounts previously received in respect of the cessation. This will ensure that the individual does not, in total, get credit for more than the actual amount so paid.

***Example***

*Rachel has options to acquire 100 shares of her corporate employer at an exercise price of $9 a share. She paid $100 ($1 a share) to acquire these options.*

*As a result of a corporate merger, the corporation whose shares she is entitled to acquire under the stock option ceases to exist. She receives one payment of $75, and a subsequent payment of $300, from the new corporation in consideration for the fact that her stock option rights have ceased to be exercisable in accordance with the terms of the agreement. The $375 represents the approximate value of the options before the merger.*

*Paragraph 7(1.7)(a) deems Rachel to have disposed of her stock option rights when she receives the $75 payment. As a result, she is deemed by paragraph 7(1)(b) to have received a benefit from employment equal to the proceeds of disposition ($75) less the amount that she paid to acquire the options ($100). Thus, the employment benefit that she is deemed to have received as a result of the first payment is nil.*

*Paragraph 7(1.7)(a) deems Rachel to have disposed of her stock option rights again when she receives the $300 payment. As a result, she is deemed by paragraph 7(1)(b) to have received a benefit from employment equal to the proceeds of disposition*

> *($300) less the amount that she paid to acquire the options. By virtue of paragraph 7(1.7)(b), the amount that she is considered to have paid for the options is now $25 (= $100 - $75). Thus, the employment benefit that she is deemed to have received as a result of the second payment is $275.*

Subsection 7(1.7) applies to amounts received on or after Announcement Date. However, such amounts are exempted from the application of subsection 7(1.7) if they are made in respect of a cessation that occurred before Announcement Date and they are made pursuant to either

> (a) an agreement in writing made before Announcement Date in settlement of claims arising as a result of the cessation, or
>
> (b) an order or judgment issued before Announcement Date in respect of claims arising as a result of the cessation.

**Securities Held by Trustee**

ITA
7(2)

Subsection 7(2) of the Act provides that, where a trust holds securities for an employee, acquisitions and dispositions of the securities by the trust are treated as acquisitions and dispositions by the employee for the purposes of section 7 and paragraphs 110(1)(*d*) and (*d*.1) of the Act.

Subsection 7(2) is amended so that it also applies for the purpose of new paragraph 110(1)(*d*.01). Paragraph 110(1)(*d*.01) allows an employee to deduct a portion of the amount of the benefit that the employee is deemed by subsection 7(1) to have received in respect of the acquisition of certain employee option securities where the securities (or, under certain circumstances, proceeds from the disposition of such securities) are donated to a qualifying charity.

This amendment applies to the 2000 and subsequent taxation years.

## Sale to Trustee for Employees

ITA
7(6)(*a*)

Subsection 7(6) of the Act provides a rule which applies where an employer (or a non-arm's length person) has entered into an arrangement under which its securities (or securities of a non-arm's length person) are sold or issued to a trustee for sale to an employee. It provides that, for the purposes of section 7 and paragraphs 110(1)(*d*) and (*d*.1), the employee's rights under the arrangement are treated as having arisen under an employee security option agreement.

Paragraph 7(6)(*a*) is amended so that this rule also applies for the purpose of new paragraph 110(1)(*d*.01). Paragraph 110(1)(*d*.01) allows an employee to deduct a portion of the amount of the benefit that the employee is deemed by subsection 7(1) to have received in respect of the acquisition of certain employee option securities where the securities (or, under certain circumstances, proceeds from the disposition of such securities) are donated to a qualifying charity.

This amendment applies to the 2000 and subsequent taxation years.

## Definitions

ITA
7(7)

Subsection 7(7) of the Act defines the expressions "qualifying person" and "security" for the purposes of section 7 and paragraph 110(1)(*d*). "Qualifying person" is defined as a corporation or a mutual fund trust. "Security" is defined as a share issued by a corporation or a unit of a mutual fund trust.

Subsection 7(7) is amended so that the definitions also apply for the purposes of new subsection 47(3), amended paragraph 53(1)(*j*), new paragraph 110(1)(*d*.01), amended subsection 110(1.5) and new subsections 110(1.6) and (2.1) of the Act.

- New subsection 47(3) exempts from the cost-averaging rule in subsection 47(1) of the Act certain securities acquired either under an employee option agreement or on withdrawal from a deferred profit sharing plan.

- Amended paragraph 53(1)(*j*) adds, to the adjusted cost base of an employee option security, the employment benefit that subsection 7(1) deems the employee to have received in connection with the acquisition of the security.
- New paragraph 110(1)(*d*.01) and subsection 110(2.1) allow an employee to deduct a portion of the employment benefit that the employee is deemed, by subsection 7(1), to have received in connection with the acquisition of a qualifying employee option security if, within 30 days of the acquisition, the employee donates the security (or proceeds from the disposition of the security) to a qualifying charity.
- Amended subsection 110(1.5) and new subsection 110(1.6) contain interpretative rules that apply for purposes of determining if the conditions for the deduction in paragraph 110(1)(*d*) are satisfied. Paragraph 110(1)(*d*) allows an employee to deduct a portion of the employment benefit that the employee is deemed, by subsection 7(1), to have received in connection with the exercise or disposition of rights under a security option agreement.

The extension of subsection 7(7) to these provisions is consequential to either the introduction of the relevant provision, or an amendment to the relevant provision. For subsections 110(1.5) and (1.6), the extension of subsection 7(7) applies after 1997. In all other cases, it applies after 1999.

## Deferral for Employee Options on Publicly-Listed Shares and Mutual Fund Trust Units

ITA
7(8) to (16)

New subsections 7(8) to (16) of the Act contain rules allowing for the deferral of taxation on the employment benefit realized when an employee acquires securities (i.e., shares of the capital stock of a corporation or units of a mutual fund trust) under an option granted by the employer or a person not dealing at arm's length with the employer, provided certain conditions are met. The deferral will cease when the employee disposes of the security, dies or ceases to be resident in Canada.

The following are the main features of the deferral measure.

- The deferral is available only in respect of securities acquired after February 27, 2000 by Canadian residents.

- If the employee option security is a share, the deferral is available only if the share is of a class of shares listed on a Canadian or foreign prescribed stock exchange. Furthermore, if the option being exercised was acquired by the employee as a result of one or more exchanges of options under subsection 7(1.4) of the Act, the shares that could be acquired under each of the previous options must also have been of a class of shares listed on a prescribed stock exchange (although an exemption may apply if the share was acquired in 2000).

- The deferral does not apply to options granted by Canadian-controlled private corporations (CCPCs), since a deferral is already available on such options under subsection 7(1.1) of the Act.

- The deferral is available only if the employee is entitled to a deduction under paragraph 110(1)(*d*). Generally speaking, an employee is entitled to a deduction under that paragraph when the following conditions are satisfied:

    - the amount paid by the employee to acquire the security was not less than the fair market value of the security when the option was granted;

    - the employee was dealing at arm's length, immediately after the option was granted, with the employer, the entity that granted the option and the entity whose securities could be acquired under the option; and

    - if the security is a share, it is an ordinary common share.

- If the employee option security is a share, the deferral is not available if the employee was, immediately after the option was granted, a specified shareholder of the employer, the corporation that granted the option or the corporation whose shares could be acquired under the option.

- The deferral is subject to an annual limit of $100,000. The limit is based on the year in which the options vest (i.e., first become exercisable), and on the fair market value of the underlying securities when the options were granted. Thus, for options vesting in a given year, an employee will be able to defer taxation on the acquisition of securities having a total fair market value (determined at the time the options were granted) not exceeding $100,000.

- The deferral is not automatic: it requires that the employee file an election with an entity that is involved in the option agreement (i.e., the employer, the entity that granted the option or the entity whose securities were acquired under the option). The elective nature of the deferral allows an employee who has options in excess of the $100,000 limit vesting in a particular year to choose those options for which the deferral will be claimed.

- The deferred amount is to be reported as a special item on the employee's T4 slip in the year in which the security is acquired. The employee is required to include the deferred amount in computing income from employment when completing the tax return for the year in which the deferral ceases.

There are a number of other provisions in the Act that relate to securities for which a deferral is provided under new subsection 7(8). First, deferral securities are subject to the rules in amended subsection 7(1.3) of the Act, which determine the order in which identical securities are disposed of by a taxpayer. Second, deferral securities are subject to the security-for-security exchange rules in amended subsection 7(1.5) of the Act, which provide for a continued deferral of the employment benefit associated with the old security, if certain conditions are met. Third, deferral securities are subject to new subsection 47(3), which has the effect of excluding such securities from the cost-averaging rule in subsection 47(1). Finally, pursuant to amended paragraph 53(1)(*j*), the employment benefit associated with a deferral security is added to the adjusted cost base of the security when the security is acquired, even though the benefit is not taxed until the employee disposes of the security. (See the commentary on those provisions, and in particular the examples provided as part of the commentary on subsection 47(3), for further details.)

**Deferral in Respect of Non-CCPC Employee Options**

ITA
7(8)

When an employee acquires a security under an option granted by an employer or a person not dealing at arm's length with the employer, paragraph 7(1)(*a*) of the Act deems the employee to have received a taxable employment benefit equal to the fair market value of the security at the time it is acquired less the amount paid by the employee to acquire the security. In most cases, the benefit is recognized in the year in which the security is acquired. However, in the case of shares acquired under options granted to arm's length employees by Canadian-controlled private corporations (CCPCs), recognition of the benefit is deferred, by virtue of subsection 7(1.1), from the year in which the employee acquires the share to the year in which the employee disposes of the share.

New subsection 7(8) of the Act extends, with some modifications and limitations, the deferral currently available for CCPC options to options granted by corporations that are not CCPCs and to options granted by mutual fund trusts. In order to be eligible for the deferral, the acquisition must be a qualifying acquisition as defined in new subsection 7(9), and the employee must file an election to defer in accordance with new subsection 7(10). (See the commentary on those subsections for further details.)

***Example***

*In 2001, Jean exercises an option to acquire a share of the capital stock of his employer. The exercise price is $10, which was the fair market value of the share when the option was granted. At the time of acquisition, the share is worth $100. The acquisition is a qualifying acquisition, as described in subsection 7(9), and Jean files an election under subsection 7(10) to defer recognition of the employment benefit in respect of the acquisition. Jean sells the share in 2003, when the share is worth $300. He owns no other shares of the employer.*

*On Jean's T4 slip for 2001, the employer reports the deferred employment benefit of $90 (= $100 - $10). In filing his tax return for 2003, Jean reports the $90 benefit as employment income as well as the capital gain of $200 (= $300 – ($10 + $90)) realized on the sale of the share.*

When recognition of an employment benefit is deferred under subsection 7(8), it is deferred until the employee disposes of the security. It should be noted that, if the employee does not sell the security before death, there will be a deemed disposition under section 70 of the Act at the time of death. Likewise, if the employee ceases to be resident in Canada before selling the security, there will be a deemed disposition under section 128.1 of the Act at the time of emigration. The exemption of certain employee option securities from the deemed disposition rules on emigration (as provided for under new subsection 7(1.6) of the Act) does not apply to securities for which a deferral is provided under subsection 7(8). Consequently, employment benefits that are deferred under subsection 7(8) will be taxed no later than the year in which the employee dies or ceases to be resident in Canada.

## Meaning of "Qualifying Acquisition"

ITA
7(9)

New subsection 7(9) of the Act sets out the requirements that must be met for the acquisition of a security under an employee option agreement to be considered to be a qualifying acquisition for the purposes of subsection 7(8). If the acquisition is a qualifying acquisition, subsection 7(8) provides for the recognition (and, thus, the taxation) of the associated employment benefit to be deferred, at the election of the employee, from the year the employee acquires the security to the year the employee disposes of the security.

In order for an employee's acquisition of a security under an option agreement to be a qualifying acquisition, the following conditions must be satisfied.

### *Timing of Acquisition*

Paragraph 7(9)(*a*) requires that the acquisition occur after February 27, 2000. There are no constraints as to when the option was granted, or when it vested (i.e., first became exercisable). Thus, for example, an acquisition of a security in 2001 will not fail to be a qualifying acquisition because the option under which the acquisition occurs was granted in 1998 and vested in 1999.

### *Entitlement to Deduction under Paragraph 110(1)(d)*

Paragraph 7(9)(*b*) requires that the employee be entitled to a deduction under paragraph 110(1)(*d*) in respect of the security. This means that the following conditions must also be satisfied.

- The amount paid by the employee to acquire the security (including any amount paid to acquire the right to acquire the security) must be not less than the fair market value of the security when the option was granted, unless the employee acquired the option as a result of one or more exchanges of options to which subsection 7(1.4) applied. Where there have been such exchanges, there are a number of conditions relating to the exercise price that must be satisfied. (See the commentary on amended paragraph 110(1)(*d*) for further details.)

- At the time immediately after the option was granted, the employee must have been dealing at arm's length with the employer, the entity granting the option and the entity whose securities could be acquired under the option. If there were any exchanges of options to which subsection 7(1.4) applied, this requirement applies to the original option.

- If the security is a share, it must be a prescribed share as described in section 6204 of the *Income Tax Regulations*. In general terms, a prescribed share is an ordinary common share.

### *Non-Specified Shareholder*

Paragraph 7(9)(*c*) requires that, at the time immediately after the option was granted, the employee not be a specified shareholder of the employer, the entity granting the option or the entity whose securities could be acquired under the option. (In general terms, a person is a "specified shareholder" of a corporation, as defined in subsection 248(1) of the Act, if the person owns, directly or indirectly, at least 10% of the issued shares of any class of the capital stock of the corporation or a related corporation.) If there were any exchanges of options to which subsection 7(1.4) applied, this condition applies to the original option since each new option is deemed to be the same as, and a continuation of, the original option.

### *Publicly-Listed Share*

Subparagraph 7(9)(*d*)(i) requires that, if the security is a share, it be of a class of shares listed on a Canadian or foreign stock exchange described in section 3200 or 3201 of the *Income Tax Regulations.*

Subparagraph 7(9)(*d*)(ii) requires that, if the option being exercised was acquired by the employee as a result of one or more exchanges of options under subsection 7(1.4) of the Act, the shares that could be acquired under each of the previous options must also have been of a class of shares that, at the time of the exchange, was listed on a prescribed stock exchange. However, this requirement does not apply to shares acquired in 2000, if the shares so acquired are of a class of shares that has been publicly-listed since the employee acquired the option under which the shares are acquired (i.e., since the time of the most recent exchange).

The requirements of paragraph 7(9)(*d*) are to ensure that the $100,000 annual vesting limit in new paragraph 7(10)(*c*) cannot be circumvented by establishing a class of shares exclusively for employee options which would have little or no fair market value at the time the options are granted but which would have the potential for growth, in absolute dollars, that is similar to other shares of the corporation.

## Election for Purposes of Subsection (8)

ITA
7(10)

New subsection 7(8) of the Act provides for the recognition (and, thus, the taxation) of the employment benefit in connection with a qualifying acquisition of an employee option security to be deferred until disposition of the security, if the employee makes an election to defer in accordance with new subsection 7(10) of the Act. It should be noted that subsection 7(13) of the Act allows an employee to revoke an election made in accordance with subsection 7(10). The effect of such a revocation is that the election is deemed never to have been made. (See the commentary on subsection 7(13) for further details.)

In order for an election to defer recognition of the employment benefit associated with the acquisition of an employee option security to be in accordance with subsection 7(10), the following conditions must be satisfied.

### *Timing, Form and Manner of Election*

Paragraph 7(10)(*a*) requires that the employee file the election on or before January 15th of the year following the year in which the security is acquired. However, if the security is acquired in 2000, the filing deadline is extended to the day that is 60 days after the day the legislation providing for the deferral receives Royal Assent.

Paragraph 7(10)(*a*) requires that the election be filed with a person who will be required to report the deferred employment benefit to the Minister of National Revenue. Under proposed subsection 200(5) of the *Income Tax Regulations*, each of the following will be jointly liable for so reporting the deferred employment benefit: the employer, the entity that granted the option and the entity whose security is acquired under the option. (See Appendix A for further details.)

Finally, paragraph 7(10)(*a*) requires that the employee file the election in such prescribed form and manner as is determined by the Minister of National Revenue.

### *Residency Status of Employee*

Paragraph 7(10)(*b*) requires that, when the employee acquires the security in respect of which the election is made, the employee be resident in Canada.

*$100,000 Annual Vesting Limit*

Paragraph 7(10)(*c*) requires that the election be in respect of a particular security which has a specified value that, when added to the total specified value of certain other employee option securities, does not exceed $100,000. The other securities that are relevant for this purpose are those in respect of which the employee has filed (at or before the time that the election in respect of the particular security is filed) an election in accordance with subsection 7(10) and that were acquired under options that vested (i.e., first became exercisable) in the same year as the option under which the particular security is acquired.

It should be noted that where options are exchanged for other options under subsection 7(1.4), the new options are deemed to be the same as, and a continuation of, the original options. Therefore, to the extent that all or a portion of the rights under the old options had vested before the exchange, a corresponding portion of the new rights would be considered to have vested at the same time as the old options.

The specified value of a security acquired under an employee option agreement is determined in accordance with new subsection 7(11) of the Act. In many instances, the specified value will be the fair market value of the security at the time the option was granted. However, if there have been exchanges under subsection 7(1.4) or the security has been subject to splits or consolidations, the specified value will be the initial fair market value adjusted to take into account such events. (See the commentary on new subsection 7(11) for further details.)

The following examples illustrate the application of the $100,000 annual vesting limit. In each example, it is assumed that all other conditions for the deferral are met.

***Example 1***

***In January 2001, Suzanne's corporate employer grants her options to acquire 16,000 company shares. The exercise price is $10 a share, which is the fair market value of the shares at the time the options are granted. Half of the options vest in 2001, the other half in 2002. Suzanne exercises all of the options in 2004, at***

*which time the shares have a fair market value of $100 each. Suzanne wishes to take maximum advantage of the deferral available under subsection 7(8).*

*The 8,000 shares that Suzanne acquired under the options that vested in 2001 have a total specified value of $80,000 (= 8,000 x $10). The 8,000 shares that Suzanne acquired under the options that vested in 2002 also have a total value of $80,000. Since the total specified value for each vesting year does not exceed $100,000, Suzanne elects to defer on all of the options.*

*On Suzanne's T4 slip for 2004, the employer reports the deferred employment benefit of $1,440,000 (= 16,000 x ($100 - $10)) as a special memo item. This amount will be taxable only when Suzanne disposes of the shares.*

***Example 2***

*The facts are the same as in example 1, except that all of the options vest in 2001.*

*Since the shares that Suzanne acquired under options that vested in 2001 have a total specified value of $160,000, which is in excess of the $100,000 vesting limit for 2001, Suzanne cannot elect to defer on all of the options. She elects to defer on 10,000 options, which have a total specified value of $100,000.*

*On Suzanne's T4 slip for 2004, the employer reports the deferred employment benefit of $900,000 (= 10,000 x ($100 - $10)) as a special memo item which is taxable only in the year of disposition, and the remaining employment benefit of $540,000 (= 6,000 x ($100 - $10)) as employment income which is taxable in 2004.*

***Example 3***

*On January 1, 2001, Mario's corporate employer grants him options to acquire 10,000 company shares. The exercise price is $10 a share, which is the fair market value of the shares at the time the options are granted. The options vest on January 1, 2003. On July 1, 2002, his employer grants him options on another 10,000 shares. The exercise price is $5 a share, which is the fair market value of the shares at that time. These options vest on*

*July 1, 2003. Mario exercises all of the $10 options on January 1, 2003, when the shares have a fair market value of $100. He exercises all of the $5 options on July 1, 2003, when the shares have a fair market value of $150.*

*The specified value of the options that vested in January 2003 is $100,000 (= 10,000 x $10). The specified value of the options that vested in July 2003 is $50,000 (= 10,000 x $5). Since the total specified value of options vesting in 2003 exceeds $100,000, Mario cannot defer on all of the options. He wishes to defer on those options which will maximize the amount of employment benefit that is deferred.*

*The employment benefit on the options exercised in January is $90 (= $100 - $10) per share and $145 (= $150 - $5) per share on the options exercised in July. Accordingly, Mario elects to defer on all of the options exercised in July (which have a specified value of $50,000 and a deferred employment benefit of $1,450,000 (= 10,000 x $145)). He also elects to defer on half of the options exercised in January (which also have a specified value of $50,000 but a deferred employment benefit of $450,000 (= 5,000 x $90)). The employment benefit of $450,000 on the remaining options exercised in January is taxable in 2003.*

*On Mario's T4 slip for 2003, the employer reports the total deferred employment benefit of $1,900,000 (= $1,450,000 + $450,000) as a special memo item which is taxable only in the year of disposition, and the remaining employment benefit of $450,000 as employment income which is taxable in 2003.*

## Meaning of "Specified Value"

ITA
7(11)

New subsection 7(11) of the Act defines the term "specified value" of a security acquired under an employee option agreement for purposes of the $100,000 annual vesting limit in new paragraph 7(10)(*c*). The $100,000 limit is relevant in determining whether or not the employee can elect to defer taxation on the employment benefit arising from the acquisition of the security.

In many instances, the specified value is the fair market value of the security at the time the option was granted. However, if there have been exchanges under subsection 7(1.4) or the security has been subject to splits or consolidations, the specified value is the initial fair market value adjusted to take into account such events.

More specifically, the specified value of a security acquired under an employee security option is defined as the amount determined by the formula A/B.

Amount A in the formula is the fair market value of a security that could be acquired under the option at the time the option was granted. Where there have been one or more exchanges under subsection 7(1.4), the original option is the option that is relevant in determining amount A since that subsection deems each new option to be the same as, and a continuation of, the original option.

Where there have been no exchanges of options and no other modifications to the number or type of securities that can be acquired under the option, amount B in the formula is "1". In any other case, amount B is the number of securities that it is reasonable to consider that the employee could acquire, after taking all such exchanges and modifications into account, in lieu of one security under the original option at the time it was granted. The most common modifications that would be relevant for this purpose (other than exchanges under subsection 7(1.4)) are structural changes, such as splits and consolidations, in the securities that are the subject of the option.

The following examples illustrate the determination of the specified value of a security acquired under an employee security option where there have been modifications to the original option.

***Example 1***

*Richard is granted an option to acquire a share for $20, which is the fair market value of the share at the time the option is granted. There is a 4-for-1 share split, with an automatic adjustment to Richard's option allowing him to acquire 4 shares at an exercise price of $5 each. Immediately after the split, Richard exercises his option and acquires all 4 shares.*

*Amount A in the "specified value" formula is $20, which is the fair market value, at the time the option was granted, of the particular security that could be acquired under the option at that time. Amount B in the formula is 4, since Richard was able to acquire 4 shares in lieu of the 1 share that could be acquired under the option at the time the option was granted. Therefore, the specified value of each share acquired under the option is $5 (= $20/4).*

***Example 2***

*Anne's employer, Company X, grants her options to acquire 10 shares. The exercise price is $10 a share, which is the fair market value of a Company X share at the time of grant. Company X is acquired by Company Y at a time when Company X shares are worth $100 each and Company Y shares are worth $200 each. Anne's options are exchanged for options to acquire 5 Company Y shares at an exercise price of $20 a share. Anne exercises the options immediately after the exchange.*

*Amount A in the "specified value" formula is $10, which is the fair market value, at the time the original option was granted, of a Company X share. Amount B in the formula is 0.5, since Anne was able to acquire only 1/2 of a Company Y share in lieu of 1 Company X share. Therefore, the specified value of each Company Y share is $20 (= $10/0.5).*

***Example 3***

*The facts are the same as in Example 2 except that, before Anne exercises the options, there is 4-for-1 split of Company Y shares. There is an automatic adjustment to Anne's options, allowing her to acquire 20 Company Y shares for $5 each. Anne exercises the options immediately after the split.*

*Amount A is $10, which is the fair market value, at the time the original option was granted, of a Company X share. Amount B is 2, since Anne was able to acquire 2 Company Y shares in lieu of 1 Company X share. Therefore, the specified value of each Company Y share is $5 (= $10/2).*

## Identical Options – Order of Exercise

ITA
7(12)

New subsection 7(12) of the Act provides a special rule for determining the order in which identical options are considered to be exercised. This is relevant primarily for purposes of applying the $100,000 annual vesting limit in paragraph 7(10)(*c*) to a particular security acquired under an employee option agreement.

In applying the $100,000 limit, it is necessary to determine the vesting year for the option being exercised (i.e., the year in which the option to acquire the security first became exercisable). It is also necessary to determine the vesting year of any other employee option securities for which the employee has elected a deferral under subsection 7(8). If there are identical options that have vested in different years, absent new subsection 7(12) it may not be possible to determine, when an option is exercised, which particular option is being exercised and, thus, what the vesting year is for the particular option.

Where this is the case, subsection 7(12) allows the employee to designate those options which are considered to have been exercised. If the employee does not so designate, identical options are considered to have been exercised in the order in which they first became exercisable, and identical options that first became exercisable at the same time, but were granted at different times, are considered to have been exercised in the order in which they were granted.

***Example***

*On July 1, 2001, Kevin's corporate employer grants him options on 20,000 company shares. The exercise price is $10 a share, which is the fair market value of the shares at that time. Half of the options vest immediately; the other half vest on July 1, 2002.*

*On July 1, 2002, Kevin's employer grants him options on another 20,000 company shares. The exercise price is $10 a share, which is the fair market value of the shares at that time. Again, half the options vest immediately; the other half on July 1, 2003.*

*On July 1, 2005, Kevin acquires 30,000 shares under his options.*

*Unless Kevin designates which particular options are considered to have been exercised, he is considered to have exercised the 10,000 options that vested on July 1, 2001 and the 20,000 options that vested on July 1, 2002 (10,000 of which were granted in 2001 and 10,000 of which were granted in 2002). Since the total specified value on the options that vested in 2001 is $100,000, Kevin can elect to defer, under subsection 7(8), the full employment benefit on those options. However, since the total specified value on the options that vested in 2002 is $200,000, he can elect to defer on only half of those options.*

*To maximize the deferral available to him, Kevin designates the options exercised as being the 10,000 options that vested on July 1, 2001 and July 1, 2003, and 10,000 of the 20,000 options that vested on July 1, 2002. This keeps him within the $100,000 limit for each vesting year and, thus, allows him to defer the employment benefit on all of the 30,000 options exercised. No deferral will be available, however, when he subsequently exercises the remaining 10,000 options that vested on July 1, 2002.*

It should be noted that the designation permitted under subsection 7(12) may be used in respect of options exercised before February 28, 2000, where the designation will allow for a deferral which might not otherwise be allowed on options exercised after February 27, 2000.

***Example***

*In 1996, Hélène is granted options that have a total specified value of $400,000. Half of the options vest in 1997; the other half in 1998. In 1999, Hélène exercises half of the options and, in July 2000, she exercises the remaining options. To maximize the deferral under subsection 7(8), Hélène chooses to designate half of the options vested in each of 1997 and 1998 as the options which she exercised in 1999. This allows her to designate the remaining options as the options which she exercised in July 2000 and, since the total specified value for options exercised and deferred from each of the vesting years does not exceed $100,000, she is able to elect to defer the employment benefit on all of the options exercised in 2000.*

## Revoked Election

ITA
7(13)

New subsection 7(13) of the Act allows for the revocation of an election made in accordance with subsection 7(10) to defer recognition of a security option benefit under subsection 7(8).

Where an election is revoked in accordance with subsection 7(13), the election is deemed never to have been made. As a result, the employment benefit associated with the acquisition of the security is taxed in the year of acquisition, rather than in the year of disposition. Furthermore, the "specified value" of the security (as defined in subsection 7(11)) ceases to be relevant for the purpose of applying the $100,000 annual vesting limit in paragraph 7(10)(*c*) to other employee option securities in respect of which the employee wishes to defer taxation under subsection 7(8).

In order for subsection 7(13) to apply, the employee must file a written revocation of the election with the person with whom the election was filed. Generally, the revocation request must be filed on or before January 15th of the year following the year in which the security was acquired. However, if the security was acquired in 2000, the filing deadline is extended to 60 days after the day on which the legislation providing for the revocation receives Royal Assent.

In being able to revoke an election, an employee has the ability to re-instate all or part of the $100,000 vesting limit for a particular year. This will be significant when the total specified value of securities that can be acquired under options vesting in that year exceeds $100,000.

***Example***

*On April 30, 2001, Francine's corporate employer grants her options to acquire 10,000 shares of the company. The exercise price is $10 a share, which is the fair market value of the shares at that time. The options vest immediately and expire on April 30, 2005. On September 30, 2001, Francine's employer grants her options to acquire another 5,000 company shares. The exercise* *price is $15 a share, which is the fair market value of the shares at that time. The options vest immediately and expire on September 30, 2005.*

*Francine exercises all of the $10 options on April 30, 2005, when the fair market value is $100 a share. She files an election at that time to defer, under subsection 7(8), recognition of the employment benefit of $900,000 (= 10,000 x ($100 - $10)). Since the total specified value of the shares in respect of which the election is made is $100,000 (= 10,000 x $10), the election fully utilizes the deferral limit for the 2001 vesting year.*

*Francine exercises the remaining options on September 30, 2005, when the fair market value is $295 a share. She wishes to defer recognition of as much of the employment benefit of $1,400,000 (= 5,000 x ($295 - $15)) as possible. However, because of the previous election on the $10 options, she has no deferral room available. Since she needs $75,000 (= 5,000 x $15) of deferral room, she immediately files with the employer a written request to revoke the election previously made on 7,500 of the $10 options. This provides her with sufficient room to make an election to defer the employment benefit on all of the $15 options.*

*On Francine's T4 slip for 2005, the benefit of $675,000 associated with the 7,500 options on which the election was revoked is reported as employment income which is taxable in 2005. The remaining benefit of $1,625,000 (= 1/4 ($900,000) + $1,400,000) is reported as a deferred amount, which is to be taxed in the year in which Francine disposes of the shares.*

## Deferral Deemed Valid

ITA
7(14)

New subsection 7(14) of the Act contains rules to allow the Minister of National Revenue to treat an invalid deferral of an employment benefit realized on the acquisition of an employee option security as a valid deferral under subsection 7(8).

Specifically, subsection 7(14) deals with situations in which an employee files an election to have an employment benefit deferred under subsection 7(8) but the conditions for the deferral are not satisfied. This could be because either the acquisition of the security in question was not a qualifying acquisition as defined in subsection 7(9) or the election was not made in accordance with subsection 7(10).

When this occurs, subsection 7(14) allows the Minister, upon so notifying the employee in writing, to treat the acquisition as having been a qualifying acquisition and to treat the employee as having made, at the time of the acquisition, an election in accordance with subsection 7(10). If the employee still holds the security at the time the notice is sent, the employee is deemed to have disposed of the security at that time and to have reacquired the security immediately thereafter, but not under an employee option agreement. (The provision deeming a disposition and reacquisition of the security does not apply for purposes of the security-for-security exchange rules in subsection 7(1.5).)

In applying the provisions of subsection 7(14), the Minister can ensure that an employment benefit that was incorrectly treated as a deferred amount under subsection 7(8), and thus was not taxed in the year of acquisition, is taxable in the year in which the Minister sends the necessary notice or, if earlier, in the year in which the security is disposed of. It also ensures that the specified value of the security in question is applied against the employee's $100,000 vesting limit for the year in which the right to acquire the security first became exercisable.

It is expected that the Minister would apply the provisions of subsection 7(14) when the year in which the security was acquired is statute-barred.

## Withholding

ITA
7(15)

New subsection 7(15) of the Act contains a special provision which has the effect of exempting employers from withholding and reporting obligations on employment benefits that employees are deemed, by paragraph 7(1)(*a*), to have received on the disposition of securities in respect of which a deferral was provided under subsection 7(8).

Under subsection 153(1) of the Act, an employer is required to withhold tax from an employee's remuneration and to remit that tax to the Receiver General on behalf of the employee and, under subsection 200(1) of the *Income Tax Regulations*, the employer is required to report the remuneration to the Minister of National Revenue in an annual information return. Remuneration, for this purpose, would normally include any amount that the employee is deemed by paragraph 7(1)(*a*) to have received as a benefit from employment in connection with the acquisition of a security under an employee option agreement.

However, where the employment benefit is in respect of a security acquired under circumstances to which subsection 7(8) applied, subsection 7(15) deems the employment benefit to be nil for the purposes of subsection 153(1). Consequently, the employer has no obligation to withhold or remit tax, or to file an information return, in respect of the employment benefit recognized on the disposition of the security. The employee is, nevertheless, required to include the full amount of the benefit in computing employment income for the year in which the disposition occurs.

It should be noted that, under proposed subsection 200(5) of the Regulations, the employer will be required, in the year in which the employee acquires the security, to report the amount of the deferred employment benefit as a special item on the employee's T4 slip. It should also be noted that, since the acquisition itself is not a taxable event, it also does not give rise to any obligation on the part of the employer to withhold or remit tax on the amount of the deferred employment benefit. (See Appendix A for further details on the reporting requirements under proposed subsection 200(5).)

## Prescribed Form for Deferral

ITA
7(16)

Under new subsection 7(16) of the Act, an employee who acquires securities under an employee option agreement, and elects to defer recognition of the related employment benefits under new subsection

7(8), is required to file a prescribed form, containing prescribed information, with the annual tax return for each year in which such securities are held.

Using this form, the employee will have to provide information on transactions relating to such securities, including acquisitions of new deferral securities and dispositions of existing deferral securities. This form will assist employees in complying with their obligations to include deferred employment benefits in computing employment income for the year in which there is a disposition of the related securities.

## Clause 3

## Income from Office or Employment – Deductions

ITA
8

Section 8 of the Act provides for the deduction of various amounts in computing income from an office or employment.

### Volunteers' Deduction

ITA
8(1)(*a*)

Paragraph 8(1)(*a*) of the Act provides for a deduction of up to $1,000 in respect of amounts received by an individual (and included in the individual's income) from a government, municipality or public authority for the performance, as a volunteer, of the taxpayer's duties as an ambulance technician, a firefighter or a person who assists in the search or rescue of individuals or in other emergency situations. This deduction is replaced by an equivalent exemption under subsection 81(4). For information on this exemption, see the commentary on new subsection 81(4).

This amendment applies to the 1998 and subsequent taxation years.

## Clergy Residence Deduction

ITA
8(1)(*c*)

Paragraph 8(1)(*c*) of the Act allows certain members of the clergy or of religious orders, as well as certain regular ministers of religious denominations, to deduct an amount in respect of their living accommodation. To be eligible for the deduction, the individuals have to be in charge of, or ministering to, a diocese, parish or congregation, or engaged exclusively in full-time administrative service by a religious order or a religious denomination. The amount of the deduction depends upon whether the living accommodation they occupy is (a) supplied to them by virtue of their employment, (b) rented by them or (c) owned by them.

Where the living accommodation is supplied by virtue of the employment, the amount of the deduction is equal to the value of the benefit derived from the supply of the living accommodation, to the extent that the value is already included in income. Where the living accommodation is rented by the clergy person, the amount of the deduction is equal to the amount of rent paid. Where the living accommodation is owned by the clergy person, the deduction is equal to the fair rental value of the living accommodation. In the latter two cases, the amount of the deduction for a particular year cannot exceed the amount of the remuneration for the year.

This amendment to paragraph 8(1)(*c*) deals with living accommodations rented or owned by individuals who are otherwise eligible to the deduction under that paragraph. In these cases, it limits the amount of the deduction to the least of three amounts:

- the individual's remuneration for the year from the office or employment,
- the greater of
    - 1/3 of the individual's total remuneration from the employment for the year, and

  - $1,000 per month (to a maximum of ten months) in the year during which an individual meets the conditions set out in subparagraphs 8(1)(*c*)(i) and (ii), and

- the rent paid or the fair rental value of the residence including utilities (this amount must be reduced by the total of all other amounts deducted in computing an individual's income from a business or from an office or employment in connection with the same accommodation). This could arise, for example, where two spouses who are members of the clergy occupy the same accommodation.

Furthermore, a clarification has been made to this paragraph in order to take into account, for the purpose of the calculation of the deduction, amounts included in the income or paid in respect of utilities provided in respect of the clergy residence.

This amendment applies to the 2001 and subsequent taxation years.

**Certificate of Employer**

ITA
8(10)

Subsection 8(10) of the Act provides that a deduction will not be allowed to an employee under certain provisions unless the employee files with the return of income a prescribed form signed by the employer to the effect that the employee met the requirements of the relevant provisions. Subsection 8(10) is amended in two ways. First, it is amended to add a reference to the clergy residence deduction in paragraph 8(1)(*c*), with respect to the requirements set out in subparagraphs 8(1)(*c*)(i) and (ii). This amendment applies to the 2001 and subsequent taxation years.

Second, it is amended to delete the previously existing reference to the volunteers' deduction. The volunteers' deduction has been replaced with an equivalent exemption under subsection 81(4). For information on this exemption, see the commentary on new subsection 81(4).

This amendment applies to the 1998 and subsequent taxation years.

## Clause 4

### Valuation of Inventory

ITA
10

Section 10 of the Act sets out rules for the valuation of inventory for the purpose of computing a taxpayer's income or loss from a business. These amendments ensure the appropriate measurement of a non-resident's income or loss from a business carried on in Canada.

### Removing Property from Inventory

ITA
10(12)

New subsection 10(12) of the Act applies to a non-resident taxpayer who ceases to use a property, described in the inventory of a business or part of a business that is carried on by the taxpayer in Canada, otherwise than by a disposition of the property. For example, subsection 10(12) applies if a non-resident taxpayer removes a property from the inventory of a business or part of a business carried on in Canada and adds that property to the inventory of a business or part of a business carried on by the taxpayer in another country. The time at which the taxpayer ceases to use the property in connection with a business or part of a business in Canada is referred to in this note as the "particular time".

Where new subsection 10(12) applies, the taxpayer is treated as having disposed of the property immediately before the particular time, for proceeds equal to the property's fair market value at that time. The taxpayer is treated as having received the proceeds in the course of carrying on the business in which the property was formerly used, in the taxation year that includes the particular time.

New subsection 10(12) applies after December 23, 1998.

## Adding Property to Inventory

ITA
10(13)

New subsection 10(13) of the Act applies to a non-resident taxpayer who adds a property (otherwise than by acquiring the property) to the inventory of a business or part of a business that is carried on in Canada by the taxpayer. For example, new subsection 10(13) applies if a taxpayer removes a property from the inventory of a business or part of a business carried on in another country and adds that property to the inventory of a business or part of a business carried on in Canada by the taxpayer. The time at which the taxpayer adds the property to the inventory of the business or part of a business in Canada is referred to in this note as the "particular time".

Where new subsection 10(13) applies, the taxpayer is deemed to have acquired the property at the particular time at a cost equal to the property's fair market value at that time.

New subsection 10(13) applies after December 23, 1998.

## Work in Progress

ITA
10(14)

Section 34 of the Act provides an exception to full accrual accounting in calculating the income of a business that is a professional practice by allowing the income to be determined without taking into account any professional work in progress at year end.

New subsection 10(14) provides, for the purposes of new subsections 10(12) and 10(13), that a property included in the inventory of a business includes professional work in progress that would be so included if paragraph 34(*a*) (the basic rule described above) did not apply. Any work in progress that would ordinarily be described in an inventory will thus be subject to the deemed disposition under subsection 10(12) or the deemed acquisition under subsection 10(13).

New subsection 10(14) applies after December 23, 1998.

## Clause 5

### Income Inclusions

ITA
12

Section 12 provides for the inclusion of various amounts in computing the income of a taxpayer from a business or property.

### Income from Business or Property – Interest

ITA
12(1)(*c*)

Paragraph 12(1)(*c*) requires that any interest received or receivable by a taxpayer in a taxation year be included in computing the taxpayer's income for the year. The existing reference in paragraph 12(1)(*c*) to subsection 12(5) is corrected to refer instead to subsection 12(4.1).

This amendment applies to taxation years that end after September 1997.

### Bad Debts Recovered

ITA
12(1)(*i*.1)

Paragraph 12(1)(*i*.1) of the Act requires an inclusion in income in respect of amounts recovered on account of bad debts, where subsection 20(4.2) of the Act applied to permit a deduction, or an allowable capital loss in respect of the debt.

Paragraph 12(1)(*i*.1) is amended, consequential to the amendments to subsections 14(1) and 20(4.2) that reflect the reduced inclusion rate for capital gains, by replacing the fraction "3/4" with the fraction "1/2". It is also amended to reflect the restructuring of subsection 20(4.2) into subsection 20(4.2) (deduction) and 20(4.3) (deemed allowable capital loss). In addition, it is restructured as a formula to improve readability. The amount required to be included in income is 1/2 of the amount recovered multiplied by the ratio of the amount that was deducted under subsection 20(4.2) in respect of the debt to the total of the amount deducted under subsection 20(4.2) in respect of the debt and the amount deemed by subsection 20(4.3) (previously part of subsection 20(4.2)) to be an allowable capital loss in respect of the debt. Subsection 39(11) of the Act deems the portion of the recovered amount that relates to the allowable capital loss to be a taxable capital gain. That is, the amount by which 1/2 of the recovered debt exceeds the amount required to be included in income under paragraph 12(1)(*i*.1) is deemed to be a taxable capital gain.

For further details, see the commentary on the amendments to subsections 14(1) to (5), 20(4.2) and 39(11).

These amendments apply in respect of taxation years that end after February 27, 2000 except that, for taxation years that end after February 27, 2000 and before October 18, 2000, the fraction to be used in calculating the amount required to be included in income is 2/3 rather than 1/2.

## Foreign Oil and Gas Production Expenses

ITA
12(1)(*o*.1)

Subsection 12(1) of the Act requires a taxpayer to include certain amounts, as income from a business or property, in computing the taxpayer's income for a taxation year. New paragraph 12(1)(*o*.1) ensures that any "production tax amount" of the taxpayer for a "foreign oil and gas business" is included in computing the taxpayer's income. Both of these terms are newly defined in subsection 126(7) of the Act, and are explained more fully in the notes to that provision.

New paragraph 12(1)(*o*.1) applies to taxation years that begin after 1999. However, in the event that a taxpayer elects to have the new foreign tax credit provisions in section 126 apply to taxation years that begin after an earlier date (but not earlier than December 31, 1994) designated by the taxpayer, new paragraph 12(1)(*o*.1) applies on the same basis.

## Clause 6

### Depreciable Property

ITA
13

Section 13 of the Act provides a number of special rules relating to the tax treatment of depreciable property. Generally, these rules apply for the purposes of sections 13 and 20 and the capital cost allowance regulations.

### Rules Applicable

ITA
13(7)

Subsection 13(7) of the Act provides rules relating to capital cost that apply where there has been a change of use of depreciable property.

ITA
13(7)(*b*) and (*d*)

Paragraph 13(7)(*b*) of the Act determines the capital cost to a taxpayer of depreciable property originally acquired for a purpose other than gaining or producing income, where the taxpayer subsequently begins to use the property for the purpose of gaining or producing income.

Paragraph 13(7)(*d*) of the Act determines the capital cost of depreciable property where the use made of the property for the purposes of gaining or producing income changes relative to other uses made of the property. Subparagraph 13(7)(*d*)(i) applies where the income-producing use has increased relative to the other uses made of the property.

The amendments to clauses 13(7)(*b*)(i)(B) and 13(7)(*d*)(i)(B) replace the references to the fraction "3/4" with references to the fraction "1/2" and references to the expression "4/3 of" with references to the word "twice". The changes are consequential to the decrease of the inclusion rate for capital gains from 3/4 to 1/2.

These amendments generally apply to changes in use of property that occur in taxation years that end after February 27, 2000. For changes in use of property that occur in a taxpayer's taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the references to the fraction "1/2" are to be read as references to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year, and the references to the word "twice" are to be read as references to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*), of the Act that applies to the taxpayer for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

ITA
13(7)(*e*)

Paragraph 13(7)(*e*) of the Act contains special rules which apply to determine the capital cost of depreciable property where the property is acquired on a direct or indirect transfer between persons who do not deal at arm's length.

The amendments to paragraph 13(7)(*e*) replace the references to the fraction "3/4" with references to the fraction "1/2" and the references to the expression "4/3 of" with references to the word "twice". The changes are consequential to the decrease of the inclusion rate for capital gains from 3/4 to 1/2.

The amendments generally apply to acquisitions of property that occur in taxation years that end after February 27, 2000. For acquisitions of property that occur in a taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000 of a person or partnership from whom the property was acquired, the references in paragraph 13(7)(*e*) to the fraction "1/2" are to be read as references to the fraction in amended paragraph 38(*a*) of the Act that applies to the person or partnership from whom the taxpayer acquired the property for the year in which such person or partnership disposed of the property. The references to the word "twice" are to be read as references to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the taxpayer for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

ITA
13(7)(*f*)(ii)

Paragraph 13(7)(*f*) of the Act applies to determine the capital cost of a property where a corporation is treated as having disposed of and reacquired depreciable property either under paragraph 111(4)(*e*) of the Act (on an acquisition of control of the corporation) or paragraph 149(10)(*b*) of the Act (where the corporation becomes or ceases to be exempt from tax under Part I of the Act on its taxable income).

The amendment to subparagraph 13(7)(*f*)(ii) replaces the fraction "3/4" with the fraction "1/2". The change is consequential to the decrease of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to acquisitions of property that occur in taxation years of a taxpayer that end after February 27, 2000 except that, for acquisitions of property that occur in a taxation year of a taxpayer that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference in subparagraph 13(7)(*f*)(ii) to the fraction "1/2" is to be read as a reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

**Definitions**

ITA
13(21)

"disposition of property"

Subsection 13(21) of the Act defines the expression "disposition of property" for the purposes of the depreciation recapture rules in section 13.

The definition is repealed as a consequence of the introduction of the new definition "disposition" in subsection 248(1).

This amendment applies to transactions and events that occur after December 23, 1998.

## Disposition of Building

ITA
13(21.1)

Subsection 13(21.1) of the Act sets out rules that in certain cases adjust a taxpayer's proceeds of disposition in respect of land and buildings disposed of by the taxpayer.

The amendment to paragraph 13(21.1)(*b*) replaces the reference to the fraction "1/4" with a reference to the fraction "1/2", as a consequence of the decrease of the inclusion rate for capital gains and losses from 3/4 to 1/2.

The amendment applies to dispositions of property that occur in taxation years of a taxpayer that end after February 27, 2000 except that, for dispositions of property that occur in a taxation year of a taxpayer that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference in paragraph 13(21.1)(*b*) to the fraction "1/2" is to be read as a reference to the fraction determined by subtracting the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year from 1. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Loss on Certain Transfers

ITA
13(21.2)

Subsection 13(21.2) of the Act defers, in certain circumstances, the realization of a loss that would otherwise arise from the transfer of a depreciable property. The subsection applies where the transferor or a person affiliated with the transferor holds the transferred property, or has a right to acquire it, 30 days after the transfer. Until any one of certain events occurs, the transferor is treated as holding a notional depreciable property the capital cost of which is, in effect, the amount of the deferred loss.

Subsection 13(21.2) currently applies only where the transferor is a corporation, partnership or trust. The subsection is amended to apply to transfers by any person or partnership. The practical effect of the change is to make the rule apply to natural persons.

The subsection is also amended to clarify subparagraph 13(21.2)(*e*)(ii), by replacing references to the "taxpayer" with references to the "transferor." This clarification does not effect any substantive change to the provision.

Amended subsection 13(21.2) applies after November 1999. An optional exception is provided where an individual disposes of a property before July 1, 2000, in a transaction that meets either of two tests. The first test is that the disposition be to a person who was obliged on November 30, 1999 to acquire the property under an agreement in writing. The second test is that the disposition be a transaction (or part of a series) the arrangements for which (evidenced in writing) were substantially advanced by November 30, 1999. Ineligible under the second test is any transaction or series of transactions a main purpose of which was to enable an unrelated person to obtain the benefit of a deduction or balance under the Act.

Where either of these tests is met, the transferor may elect not to have the first amendment described above apply to the disposition. Such an election must be made in writing and filed with the Minister of National Revenue on or before the transferor's filing-due date for the year in which these amendments receive Royal Assent.

## Deductible Expenses

ITA
13(34)

New subsection 13(34) of the Act ensures that the determination of whether a property is depreciable property is made before determining whether the cost of the property is eligible for deduction under sections 66 to 66.4, thereby resolving any circularity between the depreciable property provisions and the resource provisions (which do not apply to depreciable property).

This amendment to section 13 is consequential to new paragraph (*k*.1) of the definition "Canadian exploration property" in subsection 66.1(6) of the Act and new paragraph (*i*.1) of the definition

"Canadian development expense" in subsection 66.2(5) of the Act, which are explained in the commentary below.

This amendment to section 13 is applicable to taxation years that end after 1987 and before December 6, 1996. Paragraph 1102(1)(*a*) of the *Income Tax Regulations* (as amended by P.C. 1999-629, subsection 2(1)) provides the same result for taxation years that end after December 5, 1996.

## Clause 7

### Eligible Capital Property

ITA
14

Section 14 of the Act provides rules concerning the tax treatment of expenditures and receipts of a taxpayer in respect of "eligible capital properties" and operates on a pooling basis. Annual deductions, which are calculated as a percentage of this pool, may be claimed under paragraph 20(1)(*b*). (These deductions are referred to in these notes as "depreciation"). Eligible capital property includes goodwill, customer lists, farm quotas and licenses of indeterminate duration.

The cost of eligible capital property is recognized, for income tax purposes, in a pool system similar to the capital cost allowance (CCA) system. Unlike CCA, however, only 3/4 of the cost is added to the pool, and only 3/4 of the proceeds of disposition of eligible capital properties is credited against the pool. Any negative balance at the end of a taxation year must be included in calculating income for the year and may be comprised of a portion analogous to recaptured CCA deductions and a portion analogous to a taxable capital gain, calculated at a 3/4 inclusion rate.

With the reduction in the capital gains inclusion rate to 2/3 announced in the February 2000 budget and to 1/2 announced in the October 2000 Economic Statement and Budget Update, only 8/9 or 2/3 of gains in respect of eligible capital property (subject to recapture of depreciation claimed) need be included in computing income. The existing 3/4 inclusion rate is, however, maintained for the purpose of calculating pool balances. The 8/9$^{ths}$ and 2/3$^{rds}$ factors effectively convert the 3/4 inclusion rate for gains to a 2/3 inclusion rate for taxation years that end after February 27, 2000 and before October 18, 2000 and to a 1/2 inclusion rate for taxation years that end after October 17, 2000.

This section is also amended by adding new subsections 14 (14) and (15) of the Act. These rules relate to taxpayer migration and complement existing or proposed provisions in subsections 10(12) and (13) and 13(9), paragraph 45(1)(*d*) and new section 76.1 of the Act.

## Inclusion in Income from Business

ITA
14(1)

Subsection 14(1) of the Act requires certain amounts to be included in a taxpayer's income where, at the end of a taxation year, the amounts required to be deducted from a taxpayer's cumulative eligible capital pool (CEC pool) exceed the amounts required to be added to the CEC pool. Currently the amount required to be included in income is generally equal to the absolute value of any negative CEC pool balance (subject to adjustments related to the 1988 conversion of the pool from a 1/2 to a 3/4 inclusion rate, and to any exempt gains balance that the taxpayer retains in respect of an election regarding gains accrued to February 22, 1994 that can benefit from the capital gains exemption that existed until that time).

The current wording of subsection 14(1) generally provides one rule for individuals (existing paragraph 14(1)(*a*)) and a second rule for corporations. The amount that individuals must include in income is divided into a recapture of depreciation previously claimed, described in subparagraph 14(1)(*a*)(iv), and any remaining negative CEC pool balance (subject to the adjustments described above) in excess of the subparagraph 14(1)(*a*)(iv) amount. This remaining amount is described in subparagraph 14(1)(*a*)(v), and can be considered as being analogous to a capital gain in respect of eligible capital property. Consistent with the change to the capital gains inclusion rate for all taxpayers, subsection 14(1) is amended to replace the two rules in paragraphs 14(1)(*a*) and (*b*) with one rule of general application.

Amended subsection 14(1) applies the previous rule for individuals to all taxpayers. The change reflects the new 1/2 inclusion rate for capital gains by reducing the second amount required to be included in income (generally the absolute value of the negative CEC pool balance, less any depreciation claimed that is required to be included in income under former subparagraph 14(1)(*a*)(iv) (now paragraph 14(1)(*a*)). The reduction is accomplished by multiplying the existing formula that describes the second amount by 2/3. The second amount has an inherent recognition of the 3/4 rate because it reflects additions to and subtractions from the CEC pool calculated at 3/4. Since 2/3 of 3/4 equals 1/2, the amendment provides and appropriate recognition of the reduction in the capital gains inclusion rate.

***Example***

*Sophie has a cumulative eligible capital pool balance of $750,000 in 1999. This pool balance reflects $100,000 of depreciation claimed since Sophie began carrying on business in 1989. In January 2000, Sophie disposes of eligible capital property to Acme Corporation for proceeds of disposition of $2 million. Sophie claims no depreciation in 2000. Sophie has an exempt gains balance of $50,000, which she claims to reduce her paragraph 14(1)(b) income inclusion for 2000. Applying the amendments described above to section 14, the 2000 taxation year (December 31 year-end) results are as follows:*

*opening balance: $750,000*

*less 3/4 x $2 million proceeds of disposition*

*credit balance: (750,000)*

*recapture of depreciation claimed (amended paragraph 14(1)(a)): $100,000 income inclusion*

*residual income inclusion (amended paragraph 14(1)(b)):*
*2/3 x (A-B-C-D)*

*A is $750,000*

*B is $100,000 of depreciation*

*C (1/2 of depreciation claimed before adjustment time) is nil, and*

*D is $50,000.*

*2/3 x (750,000 - 100,000 - 50,000) = $400,000 income inclusion.*

These amendments apply to taxation years that end after February 27, 2000 except that, for taxation years that end after February 27, 2000 and before October 18, 2000, the reference to 2/3 in the formula is to be read as a reference to 8/9.

**Election re: Capital Gain**

ITA
14(1.01)

The capital gains inclusion rate change is reflected in amendments to subsection 14(1) as described above. These amendments, however, only apply where a taxpayer has a negative CEC pool balance. The result of this is that additions to the CEC pool are still made at the 3/4 rate and dispositions of eligible capital property still reduce pool balances on a 3/4 basis as well.

There may be circumstances in which a taxpayer would prefer to recognize the entire economic capital gain on eligible capital property on a 1/2 or 2/3 basis, for example, if a taxpayer has outstanding capital losses to be used but wants to conserve the CEC pool balance. New subsection 14(1.01) of the Act permits a taxpayer to elect to, in effect, remove a particular asset from the CEC pool and recognize a capital gain on the particular asset in the year as if it were ordinary non-depreciable capital property.

This election is only available to recognize gains, not losses, and is not available for goodwill or for other types of property for which the original cost cannot be determined. Further, it cannot be used to recognize a capital gain that can be sheltered by the taxpayer's exempt gains balance.

This amendment applies to taxation years that end after February 27, 2000.

## Deemed Taxable Capital Gain

ITA
14(1.1)

Subsection 14(1.1) of the Act deems certain amounts included in an individual's income in respect of eligible capital property attributable to qualified farm property to be a taxable capital gain of the individual for the purpose of the capital gains exemption in section 110.6 of the Act. The amount deemed to be a taxable capital gain is limited to the lesser of two amounts. The first amount is the amount included in the taxpayer's income under subparagraph 14(1)(*a*)(v) (now paragraph 14(1)(*b*)). The second amount is the taxable amount of the taxpayer's cumulative net gains from dispositions in the year or in a preceding taxation year commencing after 1987 of qualified farm property that is eligible capital property in respect of the business, minus the amount of such taxable net gains that have already been deemed to be taxable capital gains (either under subsection 14(1.1), or under paragraph 14(1)(*a*) as it read in respect of fiscal periods that ended before February 23, 1994).

Subsection 14(1.1) is amended consequential to the amendments to subsection 14(1), to change references to subparagraph 14(1)(*a*)(v) to references to new paragraph 14(1)(*b*).

Subsection 14(1.1) is also amended to adjust the second amount described above to reflect the reduced inclusion rate for capital gains. In order to properly reflect the taxable portion of gains for different taxation years that begin after 1987, it is necessary to amend variable A in paragraph 14(1.1)(*b*) to limit the application of the 3/4 inclusion rate for proceeds of dispositions and associated acquisition and selling costs, to dispositions that occurred in taxation years that ended before February 28, 2000, and introduce the 2/3 inclusion rate in respect of dispositions that occur in taxation years that end after February 27, 2000 and before October 18, 2000 and the 1/2 inclusion rate in respect of dispositions that occur in taxation years that end after October 17, 2000. Variable A now includes the taxable portion of net gains at the appropriate inclusion rates.

These amendments apply to taxation years that end after February 27, 2000.

## Acquisition of Eligible Capital Property

ITA
14(3)

Subsection 14(3) of the Act provides rules regarding non-arm's length transfers of eligible capital property. In those circumstances, where the vendor has claimed a capital gains exemption under section 110.6 in respect of the disposition, the eligible capital expenditure of the purchaser is reduced in order to prevent the purchaser from depreciating amounts that were exempt from capital gains tax in the hands of the non-arm's length vendor.

Subsection 14(3) is amended, consequential to the amendments to subsection 14(1) that reflect the reduced inclusion rate for capital gains. Because subsection 14(3) reduces the purchaser's eligible capital expenditure, and because eligible capital expenditures are still added to the purchaser's cumulative eligible capital pool at a rate of 3/4, the appropriate fraction in subsection 14(3) remains 4/3 of the proceeds of disposition of the vendor. However, the amount available as a deduction in respect of capital gains under section 110.6 for taxation years that end after February 27, 2000 and before October 18, 2000 must be grossed up by 9/8, and by 3/2 for taxation years that end after October 17, 2000, to correct for the reduced inclusion rate and properly reflect the portion of the proceeds of disposition that has been sheltered from taxation. For further details, see the commentary on the amendments to subsection 14(1).

These amendments apply to taxation years that end after February 27, 2000.

## Definitions

ITA
14(5)

Subsection 14(5) of the Act contains definitions that apply for the purpose of section 14, which deals with eligible capital property.

"cumulative eligible capital"

The definition "cumulative eligible capital" provides the calculation of a taxpayer's eligible capital property pool for the purpose of determining the taxpayer's allowable depreciation in respect of eligible capital property for the year.

Two amendments are proposed to the calculation of cumulative eligible capital:

1. Variable B in the cumulative eligible capital formula is an add-back for amounts previously included in income under subsection 14(1). Variable B is amended to gross up (by 3/2 and 9/8) the amount to be included in respect of income inclusions under paragraph 14(1)(*b*). This reflects the continued calculation of the cumulative eligible capital pool on a 3/4 basis, and converts the 1/2-based amount now included under paragraph 14(1)(*b*) (or the 2/3-based amount for taxation years that end after February 27, 2000 and before October 18, 2000) to a 3/4-based amount. Other amendments to variable B are consequential to the amendments to, and re-numbering of, subsection 14(1), which are described in further detail above.

2. Variable R, which is a component of variable F, is amended to update the reference to subparagraph 14(1)(*a*)(iv) by adding a reference to amended paragraph 14(1)(*a*), consequential to the re-numbering of subsection 14(1), which is described in further detail above.

"exempt gains balance"

The definition "exempt gains balance" is relevant in determining the amount by which a taxpayer is permitted to reduce the amount that would otherwise be included under amended paragraph 14(1)(*b*) in computing the taxpayer's income from a business.

Variable B is amended to update the reference to subparagraph 14(1)(*a*)(v) by adding a reference to amended paragraph 14(1)(*b*), consequential to the renumbering of subsection 14(1), which is described in further detail above.

These amendments apply to taxation years that end after February 27, 2000.

## Ceasing to Use Property in Canadian Business

ITA
14(14)

Under new subsection 14(14) of the Act, a non-resident taxpayer that at any particular time ceases to use eligible capital property in a business in Canada – otherwise than by actually disposing of the property – will be treated as having disposed of the property immediately before the particular time. The provision applies, for example, if a taxpayer removes eligible capital property from a business carried on in Canada and begins to use it in a business carried on outside Canada. The taxpayer is deemed to receive proceeds of disposition equal to the property's fair market value immediately before the particular time. If the property was previously used in a business outside Canada, the deemed proceeds are reduced by any excess of the property's fair market value when it began to be used in Canada over its cost at that time. New subsection (15) will have set the cost of the property at the lesser of its cost and fair market value at that time. Therefore, the adjustment to the deemed proceeds on removal of the property from Canada ensures that only the change in value of the property during the time it was used in the Canadian business is taken into account at the time of removal.

New subsection 14(14) applies after June 27, 1999 in respect of an authorized foreign bank, and after August 8, 2000 in any other case.

## Beginning to Use Property in Canadian Business

ITA
14(15)

New subsection 14(15) of the Act treats a non-resident taxpayer that ceases to use eligible capital property in a business outside Canada, and begins using that property in a business in Canada as having disposed of the property and reacquired it for an amount equal to the lesser of the cost of the property and its fair market value at the time immediately before it begins to be used in the Canadian business.

New subsection 14(15) applies after June 27, 1999 in respect of an authorized foreign bank, and after August 8, 2000 in any other case.

## Clause 8

### Loan to Non-Resident

ITA
17

Section 17 of the Act generally applies where a corporation resident in Canada has lent money to a non-resident and that loan remained outstanding for more than one year without the corporation including interest on the loan, computed at a reasonable rate, in computing its income. Where subsection 17(1) applies, it treats the corporation as having received interest on the loan, computed at a prescribed rate, at the end of each taxation year during which the loan was outstanding.

Subsection 17(9) of the Act provides an exception to section 17 where the corporation resident in Canada and the non-resident are unrelated and various other conditions are met. Similarly, paragraph 17(3)(*b*) provides an exception in the case of an indirect loan to which section 17 would otherwise apply if the parties to the indirect loan are unrelated and various other conditions are met. In determining whether a person is related to a corporation, subparagraph 251(5)(*b*)(i) provides that a taxpayer that has a right to, or to acquire, some shares of the corporation is deemed to own those shares.

### Special Rules – Related Person Determinations and Back-to-Back Loans

ITA
17(11.1) to (11.3)

New subsection 17(11.1) of the Act provides that, in determining whether two persons are related to each other for the purpose of section 17, certain rights referred to in paragraph 251(5)(*b*) of the Act, such as rights to acquire shares of the capital stock of a corporation, are to be ignored to the extent that, under the laws of the country in which the corporation was formed or last continued or exists that govern foreign ownership or control of the corporation, the holder of the rights is prohibited from exercising the rights.

New subsection 17(11.2) of the Act provides a rule for back-to-back loans that applies for the purposes of subsection 17(2) and paragraph 17(3)(*b*) of the Act. Where an initial lender makes a loan to an intermediate lender and that intermediate lender loans funds to the intended borrower because of that loan by the initial lender, the loan by the intermediate lender to the intended borrower is deemed to have been made by the initial lender and not by the intermediate lender to the extent of the loan made by the initial lender and under the terms and conditions established by the intermediate lender and the intended borrower.

New subsection 17(11.3) of the Act provides a rule that applies in determining if persons are related to each other for the purpose of the rules in paragraph 17(3)(*b*) of the Act, which exempts arm's length loans between unrelated persons from the back-to-back loan rules. Subsection 17(11.3) ensures that, if two conditions are met, rights held by a non-resident corporation to acquire shares of another non-resident corporation are to be ignored when determining if persons are related. The first condition is that the exercise of the rights would result in the two non-resident corporations being controlled foreign affiliates of the corporation resident in Canada. The second condition is that the loan between them would not be subject to subsection 17(1) because of subsection 17(8), which exempts certain loans between controlled foreign affiliates of the corporation resident in Canada from the application subsection 17(1).

These amendments to subsections 17(11.1) to (11.3) apply to taxation years that begin after February 23, 1998.

## Exempt Loan or Transfer

ITA
17(15)

Subsection 17(15) of the Act contains definitions that apply for the purposes of section 17 of the Act, including the definition "exempt loan or transfer" which is relevant for the purpose of subsection 17(2) of the Act. Subsection 17(2) does not apply to an exempt loan or transfer of property.

The definition "exempt loan or transfer" is amended to include

- loans made by a corporation resident in Canada where the interest rate charged is not less than an arm's length rate,
- transfers or payments made pursuant to an agreement made on arm's length terms and conditions, and
- transfers of property by a corporation resident in Canada by way of the payment of a dividend to a shareholder or the reduction of the paid-up capital of shares of the corporation.

This amendment applies to taxation years that begin after February 23, 1998.

## Clause 9

### Prohibited Deductions

ITA
18

Section 18 of the Act prohibits the deduction of certain outlays and expenses in computing a taxpayer's income from a business or property.

### Deductions – General Limitations – Interest

ITA
18(1)(*v*)

Subsection 18(1) of the Act contains a list of general deductions that are prohibited when determining a taxpayer's income. This list is expanded by adding new paragraph 18(1)(*v*) of the Act, which denies a deduction to an authorized foreign bank (newly defined in subsection 248(1) of the Act) for any amount in respect of interest that would otherwise be deductible in computing the bank's income from a business carried on in Canada, except as provided in new section 20.2 of the Act. New paragraph 18(1)(*v*) applies after June 27, 1999.

## Costs Relating to Construction of Building or Ownership of Land

ITA
18(3.1)(*b*)

Subsection 18(3.1) of the Act denies the immediate deduction of certain costs, generally referred to as construction period soft costs, relating to the construction, renovation or alteration of a building. These costs are required to be added to the cost or capital cost of the building to which they relate.

This amendment to paragraph 18(3.1)(*b*), which is consequential to the enactment of new section 20.3 dealing with weak currency debt, ensures that the amount of an outlay or expense relating to construction period soft costs is only included in the cost or capital cost of the relevant building to the extent that the amount would otherwise be deductible in computing the taxpayer's income.

This amendment applies to outlays and expenses made or incurred after December 21, 2000.

## Thin Capitalization

ITA
18(4)

Subsection 18(4) of the Act provides thin capitalization rules for corporations resident in Canada, which limit their deduction for interest on debt owing to certain specified non-residents. The interest is disallowed where the corporation's debt-equity ratio in relation to the specified non-residents exceeds 3 to 1.

Pursuant to changes announced in the 2000 Budget, subsection 18(4) is amended in three ways. First, the debt-equity ratio is changed from the present 3:1 to 2:1, effective for taxation years that begin after 2000.

Second, the method of calculating debt for the debt-equity ratio is modified, effective for taxation years that begin after 2000. Under amended paragraph 18(4)(*a*), debt is calculated based on a monthly average. This average is calculated by first noting, for each calendar month that ends in a given taxation year, the greatest total amount of the corporation's debt outstanding to specified non-residents at any time in that month. The sum of these amounts is then divided by the number of calendar months that end in the taxation year to arrive at the monthly average debt.

Third, the method of calculating equity for the debt-equity ratio is also modified, effective for taxation years that begin after 2000. While the corporation's retained earnings continue to be calculated at the beginning of the year under amended paragraph 18(4)(*a*), monthly averages are provided for calculating the corporation's contributed surplus and paid-up capital. The monthly average contributed surplus is calculated by first noting, for each calendar month that ends in a given taxation year, the amount of the corporation's contributed surplus at the beginning of that month, to the extent that it was contributed by a specified non-resident shareholder of the corporation. The sum of these amounts is then divided by the number of calendar months that end in the taxation year to arrive at the monthly average contributed surplus. A similar calculation is provided for determining the corporation's paid-up capital for the purpose of the debt-equity ratio.

## Thin Capitalization – Definitions

ITA
18(5)

Subsection 18(5) of the Act defines certain expressions for the purpose of the "thin capitalization" rules in subsections 18(4) to (8). In certain circumstances, the thin capitalization rules limit a corporation's deduction of interest expense. The application of the rules depends on the amount of the corporation's "outstanding debts to specified non-residents" – a term defined in subsection 18(5).

Paragraph (*b*) of this definition currently provides an exclusion for certain obligations owing to non-resident insurers. The paragraph is amended to provide as well an exclusion for an obligation owing to an authorized foreign bank, if the bank uses or holds the obligation in its Canadian banking business (defined in a new definition in subsection 248(1) of the Act).

This amendment applies after June 27, 1999.

## Limitation re Prepaid Expenses

ITA
18(8)

Subsection 18(8) of the Act exempts from the application of the thin capitalization rules contained in subsection 18(4) corporations whose principal business in Canada throughout the year is the development or manufacturing of aircraft or aircraft components. Pursuant to changes announced in the 2000 Budget, this exemption is repealed, effective for taxation years that begin after 2000.

## Limitation re Prepaid Expenses

ITA
18(9)(*a*)(ii)

Subsection 18(9) of the Act defers the deduction of certain prepaid expenses to the taxation year to which the expenses relate. Paragraph 18(9)(*a*) lists the prepaid amounts to which the subsection applies. Currently, these amounts include, amongst other amounts, taxes (other than taxes imposed on insurance premiums).

Subparagraph 18(9)(*a*)(ii) is amended to provide that only premium taxes imposed on an insurer in respect of a non-cancellable or guaranteed renewable accident and sickness insurance policy or a life insurance policy that is not a group term life insurance policy that provides coverage for a period not exceeding 12 months are excepted from subparagraph 18(9)(*a*)(ii) and continue to be deductible on a current basis. The amendment to subparagraph 18(9)(*a*)(ii) is consequential to the addition of subsection 18(9.02) of the Act which requires the deferral of policy acquisition costs (which include premium taxes) generally in respect of non-life insurance policies.

This amendment applies to taxation years that begin after 1999 and, where a taxpayer so elects in writing with respect to both it and new subsection 18(9.02), to the taxpayer's taxation years that end after 1997. The election is to be filed with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxation year in which this amendment receives Royal Assent.

## Application of Subsection (9) to Insurers

ITA
18(9.02)

Currently, policy acquisition costs are deductible for tax purposes on a current basis. New subsection 18(9.02) deems an outlay or expense made or incurred by an insurer on account of the acquisition of an insurance policy (other than a non-cancellable or guaranteed renewable accident and sickness policy or a life policy that is not a group term life policy that provides coverage for a period not exceeding 12 months) to be an expense incurred for services rendered consistently throughout the period of coverage of the policy. Where such acquisition costs relate to an insurance policy that covers a period extending beyond the end of the insurer's taxation year, subsection 18(9) of the Act will apply to prorate the deductibility of the costs over the period of coverage of the policy. Generally accepted accounting principles (GAAP) identify policy acquisition costs to include premium taxes, commissions, and other costs directly related to the acquisition of premiums written.

This amendment applies to taxation years that begin after 1999 and, where a taxpayer so elects in writing with respect to both it and amended subparagraph 18(9)(*a*)(ii), to the taxpayer's taxation years that end after 1997. The election is to be filed with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxation year in which this amendment receives Royal Assent.

## Clause 10

## Matchable Expenditures

ITA
18.1

Section 18.1 of the Act restricts the deductibility of an otherwise deductible "matchable expenditure" incurred in respect of a "right to receive production" by prorating the deductibility of the amount of the expenditure over the economic life of the right.

ITA
18.1(15)

Subsection 18.1(15) of the Act describes those matchable expenditures in respect of a right to receive production that are not subject to the matchable expenditure rules in section 18.1.

Concern has been expressed that the matchable expenditure rules may apply to a reinsurer's share of sales commissions or expenses incurred in respect of the issuance of an insurance policy for which all or a portion of a risk has been ceded to the reinsurer. However, the tax deferral advantage associated with expenditures of a reinsurer are already taken into account in the calculation of the policy reserves of the reinsurer.

Subsection 18.1(15) is, therefore, amended to exclude from the matchable expenditure rules expenditures of a reinsurer in respect of commissions or other expenses related to the issuance of an insurance policy for which all or a portion of a risk is ceded to the reinsurer. This exception applies only where the reinsurer and the person to whom the reinsurer made the expenditures are both insurers subject to the supervision of the Superintendent of Financial Institutions (in the case where the reinsurer is required by law to report to the Superintendent of Financial Institutions) or, in any other case, the Superintendent of Insurance or similar officer or authority of the province under whose laws the insurer was incorporated.

This amendment applies to expenditures made after November 17, 1996, the original coming-into-force date for section 18.1.

## Clauses 11 and 12

## Limitation re Advertising Expenses

ITA
19 and 19.01

Section 19 of the Act precludes the deduction of advertising expenses to the extent that the expenses are incurred for advertisements directed at the Canadian market and placed in a newspaper or periodical that does not meet certain Canadian ownership criteria.

Pursuant to the Canada-U.S. Agreement of June 3, 1999 regarding periodicals, section 19 of the Act is amended to exclude advertisements in periodicals from the application of section 19. Instead, new section 19.01 of the Act permits full deductibility of expenses for advertisements published in issues of periodicals that contain at least 80% original editorial content, and 50% deductibility for advertising expenses in other periodicals, regardless of the ownership of the periodical.

These amendments apply to advertisements in issues of periodicals published after May 2000.

In addition, new subsection 19(5.1) provides an extended meaning of "Canadian citizen", in order to ensure that Canadian pension funds and certain other entities that may own Canadian newspapers are considered to be Canadian citizens for the purpose of the ownership requirements of section 19. This amendment applies from July 1996. For periodicals, the amendment applies from July 1996 to May 2000, after which nationality of ownership ceases to be relevant in the context of periodicals.

## Clause 13

### Income from Business or Property – Deductions

ITA
20

Section 20 of the Act provides rules relating to the deductibility of certain outlays, expenses and other amounts in computing a taxpayer's income for a taxation year from a business or property.

### Cumulative Eligible Capital Amount

ITA
20(1)(*b*)

Paragraph 20(1)(*b*) of the Act provides a deduction in calculating a taxpayer's income from a business of up to 7% of the taxpayer's cumulative eligible capital pool. Consequential to the examination of the eligible capital property provisions undertaken after the 2000 budget, paragraph 20(1)(*b*) is amended to introduce a short taxation year rule for eligible capital property.

This amendment applies to taxation years that begin after December 21, 2000.

### Expenses re Financing

ITA
20(1)(*e*)

Paragraph 20(1)(*e*) of the Act provides for the deduction over a five-year period of expenses incurred in the course of issuing securities, borrowing money, and certain other financing transactions. Amounts paid in respect of the principal of a debt obligation and interest on the obligation are expressly excluded from the application of this paragraph. Paragraph 20(1)(*e*) is amended to clarify that it does not allow a deduction for profit participation and similar payments – that is, payments dependent on the use of or production from property, or computed by reference to revenue, profits, cash flow, commodity prices or any other similar criterion or by reference to dividend payments. Where such payments are compensation for the use of borrowed money or for the right to pay a debt over time, they would be excluded by the existing paragraph 20(1)(*e*) – either because they are interest or because they fall within the broad definition of "principal amount" in subsection 248(1) of the Act. The amendment ensures that in no circumstances can participation and similar payments be deducted under paragraph 20(1)(*e*).

The amendment to paragraph 20(1)(*e*) applies with respect to expenses incurred by a taxpayer after November 30, 1999, except where the expenses were incurred pursuant to a written agreement made by the taxpayer on or before that day.

ITA
20(1)(*f*)(ii)

Paragraph 20(1)(*f*) of the Act sets out rules concerning the deductibility of amounts paid by a taxpayer where the amounts paid are in respect of the principal amount of an obligation that was issued for less than its principal amount.

The amendment to subparagraph 20(1)(*f*)(ii) replaces the reference the fraction "3/4" with a reference to the fraction "1/2", as a consequence of the change of the inclusion rate for capital gains from 3/4 to 1/2. The amendment applies in respect of amounts paid after February 27, 2000 except that, for amounts paid after February 27, 2000 and before October 18, 2000 the reference to the fraction "1/2" is to be read as a reference to the fraction "2/3". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

ITA
20(1)(*z*.1)

Paragraph 20(1)(*z*.1) of the Act permits a taxpayer to deduct an amount in respect of amounts paid by the taxpayer to a lessee for the cancellation of a lease of a property where the property was not owned at the end of the year by the taxpayer or a non-arm's length person.

The amendment to paragraph 20(1)(*z*.1) replaces the reference to the fraction "3/4" with a reference to the fraction "1/2", as a consequence of the change of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies in respect of amounts paid after February 27, 2000 except that for amounts paid after February 27, 2000 and before October 18, 2000 the reference to the fraction "1/2" is to be read as a reference to the fraction "2/3". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

ITA
20(1)(*hh*)

Subparagraph 20(1)(*hh*)(i) of the Act provides a deduction for the repayment by a taxpayer of certain amounts that were included in the taxpayer's income under paragraph 12(1)(*x*) as an inducement or assistance. Subparagraph 20(1)(*hh*)(ii) provides a deduction for the repayment of certain inducements or assistance not included in the taxpayer's income under paragraph 12(1)(*x*) but that would have been so included but for the application of subparagraph 12(1)(*x*)(v.1) or subsection 12(2.2) of the Act which allow the netting of the amounts against other costs. Subparagraph 20(1)(*hh*)(ii) does not apply if the outlays or expenses related to the inducements or assistance were deductible in computing income under any of sections 66, 66.1, 66.2 or 66.4 (or would have been so deductible if certain limits on deductions under those sections were not taken into account).

Subparagraph 20(1)(*hh*)(ii) is amended so that repayments in respect of outlays or expenses deductible under new section 66.21 are likewise not deductible as a consequence of the application of that subparagraph. This amendment is consequential to the introduction of new rules for the deduction of foreign resource expenses in section 66.21.

This amendment applies to taxation years that begin after 2000.

## Bad Debts re Eligible Capital Property

ITA
20(4.2)

Subsection 20(4.2) of the Act provides a deduction in computing income of a taxpayer for a bad debt on account of proceeds of disposition of eligible capital property. The deduction is reduced to the extent that the taxpayer has sheltered an income inclusion in respect of eligible capital property using the capital gains exemption in section 110.6, or the taxpayer's exempt gains balance (as defined by subsection 14(5)) in respect of the former $100,000 lifetime capital gains exemption. The amount of the reduction is deemed to be an allowable capital loss. The exempt gains balance is available only to individuals. (In these notes, deductions claimed under paragraph 20(1)(*b*) are referred to as "depreciation".)

Subsection 20(4.2) is amended consequential to the amendments to subsection 14(1) that reflect the reduced inclusion rate for capital gains. For further detail regarding the amendments to subsection 14(1), see the commentary to that provision. Because the eligible capital property system now incorporates three fractions, one for calculating cumulative eligible capital pool balance (3/4) and two others for calculating income inclusions under subsection 14(1), (2/3 and 1/2, subject to a recapture of depreciation claimed), the amendments to subsection 20(4.2) recognize three different proportions of bad debts as deductible, depending on how the recognition of the proceeds of disposition originally affected the taxpayer. The amount deductible under subsection 20(4.2) in respect of bad debts is determined by the formula (A + B) - (C + D + E + F + G + H). The formula operates as a pool that takes into account bad debts in the year and in preceding years.

Variable A applies for taxation years that end after February 27, 2000. It is equal to the lesser of 1/2 of total bad debts and, generally, the taxpayer's income inclusion under amended paragraph 14(1)(*b*), which reflects the taxable portion of the taxpayer's gain in respect of eligible capital property. The taxpayer's income inclusion under paragraph 14(1)(*b*) reflects the 2/3 or the 1/2 inclusion rate for capital gains. Variable B is the amount by which 3/4 of the bad debt exceeds 9/8 or 3/2 of variable A. This ensures that only the appropriate fraction of the bad debt is recognized. Multiplying A by 9/8 or 3/2 converts it from a 2/3- or 1/2-based amount to a 3/4-based amount.

Variables C through H reduce the amount of the taxpayer's deduction to reflect otherwise taxable amounts that have been sheltered by deductions in respect of capital gains. Variables F and G relate to the taxpayer's claim in respect of his or her exempt gains balance, related to the $100,000 lifetime capital gains exemption, as defined in subsection 14(5). Variables F and G are only relevant for individuals. Variables C, D and E describe amounts that have been sheltered by the deduction under section 110.6 in respect of capital gains on qualified farm property. Variable H reduces the deduction by amounts deducted under the provision for prior years, to appropriately adjust the pool, which reflects all bad debts owing to the taxpayer in respect of eligible capital property.

Variables C to G are used to calculate the taxpayer's allowable capital loss under new subsection 20(4.3) as described below.

***Example***

*(The first part of this example is also set out in the commentary to the amendments to subsection 14(1).)*

*Sophie has a cumulative eligible capital pool balance of $750,000 in 1999. This pool balance reflects $100,000 of depreciation claimed since Sophie began carrying on business in 1989. In January 2000, Sophie disposes of eligible capital property to Acme Corporation for proceeds of disposition of $2 million. Sophie claims no depreciation in 2000. Sophie has an exempt gains balance of $50,000, which she claims to reduce her paragraph 14(1)(b) income inclusion for 2000. Applying the proposed amendments to section 14 described above, the 2000 taxation year results are as follows:*

*opening balance: $750,000*

*less 3/4 x $2 million proceeds of disposition*

*credit balance: ($750,000)*

*recapture of depreciation claimed (amended paragraph 14(1)(a)): $100,000 income inclusion*

*residual income inclusion (amended paragraph 14(1)(b)): 2/3 x (A-B-C-D)*

*A is $750,000*

*B is $100,000 of depreciation*

*C (1/2 of depreciation claimed before adjustment time) is nil, and*

*D is $50,000 (exempt gains balance that Sophie is claiming).*

*2/3 x ($750,000 - $100,000 - $50,000) = $400,000 income inclusion.*

*In 2001, the $2 million owed to Sophie becomes a bad debt when Acme Corporation goes bankrupt.*

*Sophie applies amended subsections 20(4.2) and (4.3) to calculate her deduction and allowable capital loss in respect of the bad debt.*

*Deduction ((A + B) - (C + D + E + F + G + H)).*

*A is the lesser of*

*(a) 1/2 of the bad debt, plus 1/2 of bad debts from prior years – $1,000,000, and*

*(b) the paragraph 14(1)(b) amount, read without reference to variable D in the 14(1)(b) formula: 2/3 x ($750,000 - $100,000) = $433,333.*

*The lesser of (a) and (b) is $433,333.*

*B is the amount by which 3/4 of the bad debt, plus 3/4 of the bad debts from prior years – $1.5 million – exceeds 3/2 of the amount determined for A: 3/2 x $433,333 = $650,000.*

*B is $1.5 million - $650,000 = $850,000.*

*(A + B) is $433,333 + $850,000 = $1,283,333.*

*C is nil, because Sophie has not claimed a deduction under section 110.6 in respect of capital gains related to an income inclusion under subsection 14(1) or (1.1).*

*F(a) is 2/3 of the exempt gains balance that Sophie claimed. 2/3 of $50,000 is $33,333.*

*D, E, F(b) and G are generally the same as C and F(a), except that they apply in respect of taxation years that ended before February 28, 2000 or taxation years that ended after February 27, 2000 and before October 18, 2000. Sophie has not claimed a deduction in respect of capital gains, or claimed anything in respect of her exempt gains balance, for taxation years that ended* *before February 28, 2000 nor for taxation years that ended after February 27, 2000 and before October 18, 2000.*

*H is nil because Sophie has not claimed an amount under subsection (4.2) for bad debts in prior years.*

*The calculation set out in subsection 20(4.2) therefore allows Sophie a deduction of $1,283,333 - $33,333 = $1,250,000. This deduction corresponds to Sophie's $400,000 income inclusion under paragraph 14(1)(b), plus her recaptured depreciation of $100,000, plus the elimination of her $750,000 pool balance; these three amounts total $1,250,000.*

*Sophie used her exempt gains balance of $50,000 in the 2000 taxation year sale of eligible capital property to shelter a portion of the gain. The $33,333 determined by variable F(a) reduces Sophie's deduction as described above in recognition of this sheltering. The amount of the reduction is $33,333, rather than $50,000, because the new formula for the calculation of Sophie's 2000 taxation year (December 31 year-end) income inclusion under paragraph 14(1)(b) introduces the factor 2/3 to the calculation. (In other words, $33,333 will shelter the same amount of gain under a 1/2 inclusion rate system as $50,000 did under a 3/4 inclusion rate system. In both cases $66,667 can be sheltered.) The amount of the reduction in variable F(a) is deemed by subsection 20(4.3) to be an allowable capital loss, as described below.*

The additional rule set out in existing paragraphs 20(4.2)(*b*), (*c*) and the "postamble" (which provides that the reduction of the deduction to recognize untaxed capital gains is deemed to be an allowable capital loss) are being moved to new subsection 20(4.3).

**Deemed Allowable Capital Loss**

ITA
20(4.3)

New subsection 20(4.3) of the Act provides that where a taxpayer's deduction under subsection 20(4.2) is reduced to recognize the taxpayer's use of a capital gains deduction to offset an income inclusion under subsection 14(1), the taxpayer is deemed to have an allowable capital loss. The allowable capital loss, in effect, restores the capital gains deduction that was used up in sheltering a gain on what turned out to be a bad debt. The allowable capital loss is equal to the lesser of two amounts. The first amount is 1/2 of the total bad debts. The second amount is the capital gains exemption amounts or exempt gains balance used up in respect of dispositions of eligible capital property under the 1/2 inclusion rate system, plus 3/4 of capital gains exemption or exempt gains balance used up in respect of dispositions of eligible capital property under the 2/3 inclusion rate system plus 2/3 of capital gains exemption or exempt gains balance used up in respect of dispositions of eligible capital property under the 3/4 inclusion rate system. The use of the fraction 3/4 converts the 2/3-based exemption claims to a 1/2 basis for the purpose of calculating an allowable capital loss that will be used to offset capital gains that are included at 1/2. The fraction 2/3 converts the 3/4-based exemption claims to the same rate basis.

These amendments apply in respect of taxation years that end after February 27, 2000 except that, for taxation years that end after February 27, 2000 and before October 18, 2000, the fractions used will be adjusted to reflect a 2/3 inclusion rate. In particular, the references to 1/2, 3/2 and 2/3 are to be read as references to 2/3, 9/8 and 8/9, respectively, and subparagraph 20(4.3)(*b*)(ii) is to be read without the expression "3/4 of".

## Clause 14

## Interest – Authorized Foreign Bank

ITA
20.2

New section 20.2 of the Act contains rules that allow an authorized foreign bank operating in Canada to deduct, in computing its income from its Canadian banking business for a taxation year, amounts on account of interest expense. Given new paragraph 18(1)(*v*) of the Act (see separate note), this new section is comprehensive and exclusive: in computing its Canadian business income, an authorized foreign bank may only deduct amounts on account of interest that are authorized under section 20.2.

Under new section 20.2, each taxation year of an authorized foreign bank is divided into "calculation periods," which may be designated by the bank in its tax return for the year, subject to certain conditions described below, or, in the absence of such a designation, by the Minister of National Revenue. The amount that the bank may deduct on account of interest for a given year is the total of the deductible amounts determined for all the calculation periods in the year. Those deductible amounts may include one or more of the following:

- Interest expense actually incurred by the bank in the period, in relation to actual liabilities of the Canadian banking business to other persons or partnerships;

- Interest expense notionally incurred by the Canadian banking business in the period, in relation to documented "branch advances" from the bank itself to the business; and

- A residual amount, representing interest for the period calculated at the Bank of Canada bank rate on an amount not exceeding the amount by which 95% of the value of the Canadian banking business's assets exceeds the total of its actual liabilities and its branch advances.

These three categories of branch interest expense reflect the fact that an authorized foreign bank's Canadian operations may be funded through some combination of three sources of funds. First, the bank may, in the course of its Canadian operations, borrow directly from other persons or partnerships, recording the resulting obligation as a liability of the Canadian business itself. Second, the bank – typically, the bank's head office or other central source of internal financing – may advance funds to the Canadian business, with the lending unit recording the advance in more or less the same way it would an arm's length loan (and applying comparable terms – see below) and the branch recording it as a notional liability. Third, the bank may use its own, undifferentiated funds to operate the branch, without formally recording an advance to the branch.

Regardless what combination of these three sources is used for a given calculation period, section 20.2 limits the amount that the authorized foreign bank may deduct on account of its Canadian business's interest expense. On the principle that an authorized foreign bank's capital structure will include at least 5% of equity, interest is not deductible to the extent it reflects debt in excess of 95% of the value of the assets of the Canadian banking business at the end of the period.

Reference should also be had to the relationship between interest expense deductions under new section 20.2 and the "branch tax" under Part XIV of the Act, described in connection with the amendments to that Part.

New subsection 20.2 applies after June 27, 1999, except that a special transitional rule (described in the detailed notes to subsection 20.2(1), below) applies to branch advances made before August 22, 2000.

## Definitions

ITA
20.2(1)

New subsection 20.2 (1) of the Act sets out definitions for the purposes of new section 20.2.

"branch advance"

A branch advance of an authorized foreign bank means an amount allocated or provided by or on behalf of the bank to or for the benefit of the bank's Canadian banking business under terms that are documented, before the amount is allocated or provided, in a manner similar to the bank's documentation of loans to arms-length parties. It is contemplated that the documentation would relate to terms of the advance itself such as currency, amounts, further advances, time when repayment is required, computation of interest, payment of interest, prepayment rights, extensions and other amendments to terms, use of the funds, and whether or not the loan is considered to be secured. However, separate documentation setting out the terms of such security would not be required.

To accommodate authorized foreign banks that may already have begun to finance their Canadian operations, the requirement for prior documentation is modified in the case of branch advances made before August 22, 2000. Such advances need only be documented on or before December 31, 2000.

"branch financial statements"

The branch financial statements of an authorized foreign bank for a taxation year are the unconsolidated statements of assets and liabilities, and income and expenses, for that year in respect of its Canadian banking business that are required, under the *Bank Act*, to be prepared and filed with the bank's annual report to the Superintendent of Financial Institutions. If no such statements are required to be prepared for the taxation year, the term refers to statements that are prepared in a manner consistent with those that are required to be prepared for the annual report so filed.

If the Minister of National Revenue demonstrates that the statements described above are not prepared in accordance with generally-accepted accounting principles (GAAP) in Canada (subject to any modifications applicable to the bank specified by the Superintendent), the definition refers to the statements as they would be required to be amended to comply with GAAP.

"calculation period"

A calculation period of an authorized foreign bank for a taxation year means any of a series of regular periods into which the year is divided in a designation by the bank or in a designation by the Minister of National Revenue, such that:

- the periods in the year are regular (as, for example, monthly, weekly or daily);
- no period is longer than 31 days;
- the year's first period starts at the beginning of the year, and its last one ends at the end of the year; and
- except as authorized in writing by the Minister, the year's periods are consistent with the periods designated for the preceding taxation year.

## Formula Elements

ITA
20.2(2)

New subsection 20.2(2) of the Act sets out five elements that are used in the formulas contained in new subsection (3) (described below). These elements, which are set out in terms of a given calculation period during the taxation year of an authorized foreign bank, are importantly qualified by new subsection (4) (described below).

The elements are identified with letters that reflect their meaning.

| | |
|---|---|
| A | is the amount of the bank's assets used in the Canadian banking business at the end of the relevant calculation period. |
| BA | is the amount of the bank's branch advances at the end of the period. |
| IBA | is that total of all reasonable amounts on account of notional interest for the period, with respect to branch advances, that would (but for new paragraph 18(1)(*v*) and section 20.2 itself) be deductible if the branch advances were actual indebtedness of the bank to another person and if paragraph 18(1)(*v*) were ignored. New subsection 20.2(5) of the Act (described below) provides additional guidance as to what is a reasonable amount on account of notional interest. |
| IL | is the total of all amounts on account of interest for the period in respect of a liability of the bank in respect of the Canadian business to another person or partnership that would, but for new paragraph 18(1)(*v*) and section 20.2 itself, be deductible. |
| L | is the amount of the bank's liabilities in respect of the Canadian business to other persons and partnerships at the end of the period. |

## Interest Deduction

ITA
20.2(3)

The core of new section 20.2 of the Act is new subsection 20.2(3). This subsection contains formulas that are used to calculate the amount deductible, in computing the Canadian business income of an authorized foreign bank, on account of interest expense for each calculation period of the bank in a taxation year. The bank's maximum deduction on account of interest for the year will be the total of the amounts determined under these formulas for each of the calculation periods in the year.

An ordering principle underlies subsection 20.2(3). Interest expense is deductible first in respect of actual liabilities of the Canadian banking business to other persons or partnerships, to the extent those liabilities do not exceed 95% of the business's assets. Next, to the extent those liabilities are equal to less than 95% of the business's assets, interest may be deducted in respect of branch advances. Finally, if liabilities and branch advances together are less than 95% of assets, the bank may choose to deduct interest, computed by reference to the Bank of Canada bank rate, in respect of a residual "top-up" amount not exceeding the amount by which the 95% figure exceeds the total of liabilities and branch advances.

More specifically, subsection 20.2(3) applies one of three different formulas to the interest-deductibility calculation for a given calculation period. First, if the bank's liabilities to others (element L) at the end of the calculation period by themselves are greater than or equal to 95% of its assets (A), the formula set out in new subparagraph 20.2(3)(*a*)(ii) applies for the period. That formula generally allows the bank to deduct that proportion of its actual interest expense in respect of liabilities to others (IL) that 95% of its assets (A) is of its liabilities (L).

Second, if the bank's liabilities to others (L) and its branch advances (BA) at the end of the calculation period total 95% or more of the amount of its assets (A) at that time, but its liabilities alone (i.e. without its branch advances) are less than that 95% figure, the formula set out in new subparagraph 20.2(3)(*a*)(i) applies for the period. In broad terms, that formula allows the bank to deduct its actual interest expense in respect of liabilities to others (IL), together with that proportion of its notional interest expense in respect of branch advances (IBA), that the excess of 95% of its assets is of its liabilities.

Third, if liabilities to others (L) and branch advances (BA) at the end of the calculation period total less than 95% of assets (A), the bank may deduct the total of its actual interest expense in respect of liabilities (IL), its notional interest in respect of its branch advances (IBA), and interest at a specified rate on a residual top-up amount described in new subparagraph 20.2(3)(*b*)(ii) of the Act. That top-up amount is any amount the bank chooses to claim, not exceeding the amount by which 95% of assets (A) exceeds the total of liabilities (L) and branch advances (BA). The interest rate applicable to this elective top-up is the average, based on daily observations, of the Bank of Canada bank rate for the calculation period.

### Branch Amounts

ITA
20.2(4)

New subsection 20.2(4) applies in determining the amounts in the descriptions of the formula elements in subsection 20.2(2) – which are used in the formulas in subsection 20.2(3) – and the amounts of an authorized foreign bank's assets, liabilities and branch advances for the purpose of subsection 20.2(3). Subsection 20.2(4) provides that these amounts must be in respect of the bank's Canadian banking business only, and must be recorded in the business's books of account in a manner consistent with the manner in which they are required to be treated for the purposes of the branch financial statements. Effectively, no deduction is permitted in respect of interest or liability amounts that are not recorded in the bank's books of account.

### Notional Interest

ITA
20.2(5)

New subsection 20.2(5) of the Act provides clarification as to what constitutes, in applying the formula element "IBA" set out in subsection 20.2(2), a reasonable amount on account of notional interest in respect of a branch advance. A reasonable amount is described in subsection (5) as the amount that would be payable by a notional borrower, having regard to the time to repayment, the currency and all other terms, if:

- the notional borrower were a person dealing at arm's length with the bank, and carried on the bank's Canadian banking business and had the same credit-worthiness and borrowing capacity as the bank;

- the branch advance were a loan by the bank to the notional borrower; and

- the terms of the advance – excluding the interest rate itself, but including such terms as the method of calculating the interest rate where it is a structured rate that relies on external references, the currency of the loan, the time to repayment, provisions for early repayment and amendment – were terms that would be agreed to by the bank and the notional borrower, having regard to all the circumstances (including but not limited to the nature of the Canadian banking business, the use of the advanced funds, the presence or absence of a hedge and normal banking practice).

In essence, a reasonable amount of interest is the amount that would be payable in the circumstances in a transaction between arm's length parties if the other terms of the advance themselves were those that would be agreed to in the circumstances by such parties.

### Weak Currency Debt

ITA
20.3

New section 20.3 of the Act limits the deductibility of interest expenses and adjusts foreign exchange gains and losses in respect of weak currency debts and associated hedging transactions.

Where a currency is weak, in that it is expected to decline in value relative to a reference currency, the interest rate on a loan in the weak currency will generally be higher than on a loan on similar terms in the reference currency. The higher rate reflects the market's expectation that the amount of the loan expressed in the weak currency will be worth less in terms of the reference currency when the loan is repaid. Lenders generally demand a higher interest rate to compensate for this expected depreciation. If, as expected, the weak currency depreciates, the borrower will realize a foreign exchange gain when the principal of the loan is repaid in the depreciated foreign currency. In economic terms, this gain compensates for the higher interest payments made during the term of the loan. Hedging transactions may be used to fix the reference currency cost of the interest and principal payments that are required to be made in the weak currency.

To ensure certainty, new section 20.3 sets out specific rules concerning the taxation of weak currency debts to the debtor.

## Interpretation

ITA
20.3(1)

New subsection 20.3(1) of the Act defines several terms that are used in section 20.3.

"exchange date"

Under paragraph 20.3(2)(*a*) of the Act, the limitation on deductibility of interest in respect of a weak currency debt (also defined in subsection 20.3(1)) applies as of the "exchange date" in respect of the debt. This expression is defined in two ways reflecting two different circumstances. If the weak currency debt is incurred or assumed by the taxpayer in respect of borrowed money denominated in the final currency (defined within the definition "weak currency debt"), the exchange date is the day the debt was assumed or incurred. On the other hand, if the debt is incurred or assumed in respect of borrowed money that is not denominated in the final currency, or in respect of the acquisition of property, the exchange date is the day on which the taxpayer uses the borrowed money or the acquired property, directly or indirectly, to acquire funds or settle an obligation denominated in the final currency. Thus, where the taxpayer holds the borrowed funds or acquired property for a period of time before using them to acquire funds, or settle an obligation, in a different currency, the interest limitation rule does not apply until that initial conversion takes place. The use of the phrase "directly or indirectly" is intended to cause the exchange date to be the date of the first such conversion in currency, even if the initial conversion is an intermediate step to a subsequent conversion into the final currency.

"hedge"

The expression "hedge" is defined in respect of a weak currency debt as any agreement that can reasonably be regarded as having been entered into by the taxpayer primarily to reduce the risk of fluctuations in the value of the weak currency, relative to the final currency of use or some other currency of reference such as Canadian currency, in respect of interest or principal payments on the debt.

It is contemplated that hedges could be in a variety of legal forms such as forward and futures contracts, options, swaps and long positions in assets denominated in foreign currency. A hedge need not eliminate all risk associated with currency exposure in a weak currency debt; a contract that serves to reduce risks only partially is included.

In order to be treated as a hedge for the purposes of section 20.3, an agreement must also be identified by the taxpayer as a hedge in respect of the particular weak currency debt in a designation filed with the Minister of National Revenue within 30 days of the taxpayer entering into the hedge agreement. This requirement for up-front identification of the hedge is designed to eliminate any incentive to report or not report the existence of a hedge based on hindsight regarding its performance.

While this definition generally applies to taxation years that end after February 27, 2000, for hedge agreements entered into prior to July 2000, a hedge designation is considered timely if it is filed on or before the later of July 31, 2000 and the 30th day after the day the taxpayer agrees to the hedge.

"weak currency debt"

A "weak currency debt" is defined as a debt denominated in a foreign currency – the weak currency – that is incurred or assumed by the taxpayer after February 27, 2000 in respect of either a borrowing of money or an acquisition of property and that meets a number of other conditions set out in the three paragraphs of the definition.

Paragraph (*a*) of the definition sets out several alternative conditions, of which one must be met, linking the weak currency to another currency – referred to as the "final currency" – used directly for earning income. The final currency is defined with respect to whichever of these conditions is met. Each subparagraph requires that in order to constitute the final currency, the associated funds must be used, or the associated obligation be incurred or assumed, for the purpose of earning income and not to acquire funds in a different currency. This ensures that if the transaction involves conversion into an intermediate currency or currencies before conversion to the currency employed in the direct income-earning use, only the last currency, directly used for earning income, is considered the "final currency".

The four alternatives are as follows:

(i) the borrowed money advanced by the lender is in the final currency but the taxpayer is obliged to repay the debt in the weak currency.

(ii) the taxpayer uses the borrowed money or acquired property, directly or indirectly, to acquire funds in the final currency. This condition encompasses cases where the weak currency is exchanged into one or more other currencies as an intermediate step prior to being exchanged into the final currency. An example involving property would be the purchase of a commodity on credit where the debt for the unpaid purchase price is denominated in the weak currency and the commodity is subsequently sold for proceeds denominated in the final currency, or sold for proceeds that are used to purchase funds in the final currency.

(iii) the taxpayer uses the borrowed money or acquired property, directly or indirectly, to settle an obligation in the final currency.

(iv) the taxpayer uses the borrowed money or acquired property, directly or indirectly, to settle a prior weak currency debt, where the final currency of the prior debt is a currency other

> than the currency of the new debt. This condition encompasses cases where an original weak currency debt is refinanced with a replacement weak currency debt in the same or a different currency.

Paragraph (*b*) of the definition specifies that, to be considered a weak currency debt, a debt must be of an amount exceeding $500,000. In determining whether this threshold is met, the debt is combined with any other weak currency debts (that is, debts that would be weak currency debts but for the $500,000 threshold) that were incurred or assumed by the taxpayer as part of a series of transactions. This ensures, for example, that the rules cannot be avoided by structuring a weak currency borrowing as a series of smaller borrowings each of which is exempt because it is below the size threshold.

Paragraph (*c*) of the definition provides that a debt is only considered a weak currency debt if the interest rate in the weak currency is more than two percentage points (200 basis points) higher than the interest rate that would have obtained in the final currency if the taxpayer had incurred an equivalent amount of debt in the final currency on the same terms, other than the rate of interest. For this purpose, terms other than the interest rate may be varied, but only to the extent required to accommodate the currency difference – e.g. where comparable debt markets in the two currencies have different conventions as to interest payment dates.

New subsection 20.3(1) applies to taxation years that end after February 27, 2000.

### Interest and Gain

ITA
20.3(2)

New subsection 20.3(2) of the Act sets out several substantive rules that apply to a taxpayer that is a debtor in respect of a weak currency debt. These rules do not apply to a corporation that is a bank, trust company, credit union or a corporation whose principal business is lending money at arm's length.

Paragraph 20.3(2)(*a*) limits the amount that may be deducted on account of interest expense in respect of a weak currency debt to the amount that would have been deductible under the Act if the taxpayer had instead incurred or assumed an equivalent amount of debt in the final currency (defined within the definition "weak currency debt" in subsection 20.3(1)) on the same terms (other than the rate of interest). Under the Act, the deductible interest on such a final currency borrowing could not exceed a reasonable amount, generally determined based on market interest rates in the final currency on debts negotiated at the same time and on the same terms as the weak currency debt. Thus, if a taxpayer borrows in a weak currency and converts the proceeds into another currency – the final currency – for use to earn income, the interest deduction for any particular period is limited to the amount that would have been deductible for that period if the taxpayer had instead borrowed directly, and paid interest, in the final currency.

The limitation in paragraph 20.3(2)(*a*) applies with respect to interest that accrues on a weak currency debt after the later of June 30, 2000 and the exchange date (defined in subsection 20.3(1)) in respect of the debt.

Paragraph 20.3(2)(*b*) provides that any foreign exchange gain or loss on the settlement or extinguishment of the weak currency debt is on income account. Regardless of whether the debt itself is considered to be on capital or income account, it is considered appropriate to treat the foreign currency gains or losses on income account, since foreign exchange gains and losses anticipated by the market will typically be reflected in interest rates and the Act allows deductibility of interest expense.

Paragraph 20.3(2)(*c*) provides that, for the purpose of computing the taxpayer's foreign exchange gain or loss on the settlement or extinguishment of a weak currency debt, any interest expense for which a deduction is denied by new subsection 20.3 is deemed to be an amount paid by the taxpayer to settle or extinguish the debt. This rule ensures that the amount of denied interest reduces the amount of any foreign exchange gain on settlement and increases the amount of any foreign exchange loss on settlement. In economic terms, the higher interest cost of the weak currency debt is generally expected to be offset by a foreign exchange gain on maturity. Since deductibility of the excess interest cost is denied under paragraph 20.3(2)(*a*), it is considered appropriate to reduce the amount of the foreign exchange gain (or increases the amount of the foreign exchange loss) for tax purposes in recognition that the expected gain or loss can be viewed as compensation for the excess interest expense.

New subsection 20.3(2) applies to taxation years that end after February 27, 2000.

## Hedges

ITA
20.3(3)

New subsection 20.3(3) of the Act indicates how the rules in subsection 20.3(2) are to be applied when a taxpayer has entered into a hedge (defined in subsection 20.3(1)) in respect of a weak currency debt. In applying those rules, the amount (which under the Act is measured in Canadian dollars) paid or payable in the weak currency on account of interest or principal on the debt is decreased by the amount of any foreign exchange gain, or increased by the amount of any foreign exchange loss, on the hedge in respect of the amount so paid or payable. This ensures that in applying the rules in subsection 20.3(2), the hedge is integrated with the weak currency debt.

Thus, with respect to interest expenses, it is the taxpayer's net interest cost incorporating hedge gains or losses that is taken into account rather than the interest cost based solely on the current Canadian dollar value of the interest amounts paid or payable. Likewise, with respect to principal payments, it is the net amount repaid incorporating hedge gains or losses that is taken into account rather than solely the current Canadian dollar value of the principal amount paid.

As a result, if paragraph 20.3(2)(*b*) deems a foreign exchange gain or loss to be on income account, a hedge in respect of the exchange rate movements that produce the gain or loss will also be on income account.

New subsection 20.3(3) applies to taxation years that end after February 27, 2000.

## Repayment of Principal

ITA
20.3(4)

New subsection 20.3(4) of the Act deals with repayments and other reductions in principal owing under a weak currency debt. If the principal amount outstanding (expressed in the weak currency) is reduced before maturity, the amount of the reduction is deemed to have been a separate debt from the time the debt was incurred or assumed by the taxpayer. This ensures that the rules in section 20.3 will operate on each portion of the debt. Thus, for example, paragraph 20.3(2)(*a*) will limit the amount of interest deductible in respect of a particular portion of the debt based on a comparison with the interest that would have been deductible if an amount equivalent to the particular portion had been borrowed in the final currency. The operation of the rule in respect of the particular portion will not be affected by the repayment of another portion of the principal.

The separate debt rule does not apply for the purpose of determining the rate of interest that would have been charged in the final currency. This ensures that the comparable final currency interest rate is the one that would apply to a borrowing of the entire original amount of the principal, not the rate that would apply to a separate borrowing of a portion of that amount, which might be a higher rate due to a loss of economies of scale. Similarly, the $500,000 threshold in paragraph (*b*) of the definition "weak currency debt" in subsection 20.3(1) is applied to the entire principal amount and not to any portion of it segregated by the deeming rule.

Subsection 20.3(4) applies to taxation years that end after February 27, 2000.

## Clause 15

## Borrowed Money Used for Exploration and Development

ITA
21(2) and (4)

Subsections 21(2) and (4) of the Act apply where a taxpayer has used borrowed money for the purpose of incurring specified resource expenses. Where the taxpayer so elects, financing costs in respect of the borrowed money are not deductible under any of paragraphs 20(1)(*c*) to (*e*.1) in computing the taxpayer's income. Instead, except where the deduction under one of those paragraphs relates to exempt income (as defined in subsection 248(1)), those costs are added to the category of resource expenses that the borrowed money was used to incur. The election under subsection 21(2) is made in connection with financing costs incurred in the taxation year during which the related resource expenses were incurred. Elections under subsection 21(4) are made in connection with financing costs incurred after that year, and can only be made for a taxation year if treatment under section 21 has been chosen for all preceding taxation years with regard to the borrowed money to which the financing costs related.

Subsections 21(2) and (4) are amended so that the exception referred to above for exempt income extends to all income that is exempt from tax under Part I of the Act. This amendment is made for consistency with proposed paragraph (*l*) of the definition "investment tax credit" in subsection 127(9) and ensures that subsections 21(2) and (4) cannot be used by entities exempt from tax under subsection 149(1).

Subsections 21(2) and (4) are also amended so that the resource expenses specified under those subsections include foreign resource expenses (as defined in the definition "foreign resource expense" in new section 66.21), determined on a country-by-country basis. This amendment is consequential to the introduction of new rules in section 66.21 for the deduction of foreign resource expenses.

These amendments apply to taxation years that begin after 2000.

## Clause 16

### Business Carried on by Spouse, Common-Law Partner or Corporation

ITA
24(2)(*d*)

Subsection 24(2) of the Act provides a rollover of the cumulative eligible capital of a business of an individual who ceases to carry on the business in circumstances where the eligible capital property of the business is acquired by the individual's spouse or common-law partner or by a corporation controlled by the individual that thereafter carries on the business.

Paragraph 24(2)(*d*) deals with the calculation of income inclusions under subsection 14(1) for the spouse, common-law partner or corporation. Paragraph 24(2)(*d*) is amended consequential to the re-numbering of subsection 14(1), which is described in further detail above.

These amendments apply to taxation years that end after February 27, 2000.

## Clause 17

### Prescribed Federal Crown Corporations

ITA
27(2)

Section 27 of the Act provides special rules for the application of Part I to federal Crown corporations. It allows the Governor in Council to impose income tax on such corporations by prescribing them under the *Income Tax Regulations* Subsection 27(2) provides that the tax exemption provided under paragraph 149(1)(*d*) of the Act does not apply to a corporation controlled by a prescribed federal Crown corporation. The amendment to subsection 27(2), which adds a reference to the tax exemptions provided under paragraphs 149(1)(*d*.1) to (*d*.4), is consequential to the amendment to paragraph 149(1)(*d*) and the addition of paragraphs 149(1)(*d*.1) to (*d*.4) that were made applicable to taxation years and fiscal periods that begin after 1998.

This amendment applies to taxation years and fiscal periods that begin after 1998.

## Clause 18

### Farming or Fishing Business – Non-Resident

ITA
28(4) and (4.1)

Section 28 of the Act provides rules concerning the computation of income for taxpayers who, for income tax purposes, use the cash-basis method of accounting in respect of farming or fishing businesses. Subsection 28(4) applies, under certain conditions, to require the inclusion of the value of a non-resident taxpayer's accounts receivable in calculating the taxpayer's income for the year. Subsection 28(4.1) applies, under certain circumstances, to treat a non-resident taxpayer as having disposed of inventory owned by the taxpayer for proceeds of disposition equal to its fair market value.

Subsection 28(4) is amended, for the 1998 and subsequent taxation years, as a consequence of changes to section 114 of the Act. The amendment makes no substantive change, but keeps the reference in step with the changes to section 114. For more information about the changes to section 114, see the commentary on that section.

With the addition of new subsection 10(12) and the amendment of section 128.1 of the Act (changes in residence), subsection 28(4.1) has become redundant, and is repealed with application after December 23, 1998.

## Clause 19

### International Banking Centres – Definitions

ITA
33.1(1)

Section 33.1 of the Act provides special rules for "international banking centres" (IBCs). Subsection 33.1(1) defines certain terms used in the section.

The definition "foreign bank" in subsection 33.1(1) is amended to provide that an authorized foreign bank is not considered to be a foreign bank with respect to its Canadian banking business.

This amendment applies after June 27, 1999.

## Clause 20

### Prospectors and Grubstakers

ITA
35

Section 35 of the Act applies where:

- a share of the capital stock of a corporation is received by a taxpayer, and
- as detailed in paragraphs 35(1)(*a*) and (*b*), the consideration is "mining property" (as defined in subsection 35(2)) that is linked with prospecting or exploring.

Where section 35 applies, paragraph 35(1)(*c*) provides that the receipt of the share does not result in any immediate income inclusion. Other rules in subsection 35(1) govern the tax consequences resulting from the disposition of the share and the acquisition of the mining property.

The definition "mining property" in subsection 35(2) is amended so that it extends only to minerals in a mineral resource in Canada.

"Mineral resource" is defined in subsection 248(1). This amendment is consequential to the introduction of new section 66.21, which deals with foreign resource expenses.

This section applies to shares received after December 21, 2000.

## Clause 21

### Scientific Research and Experimental Development

ITA
37(1)

Section 37 of the Act sets out the rules governing the deductibility of expenditures incurred by a taxpayer for scientific research and experimental development (SR&ED).

Under subsection 37(1), certain expenditures incurred by a taxpayer for SR&ED carried on in Canada are accumulated in a SR&ED pool. All or a portion of the undeducted balance of the pool at the end of a taxation year may be deducted in that year. Any remaining balance of the pool at the end of a taxation year may be carried forward to be deducted in a subsequent taxation year.

New paragraph 37(1)(*d*.1) provides for the reduction of a corporation's SR&ED pool for a taxation year by its super-allowance benefit amount (a new expression defined in subsection 127(9) of the Act) for the year and preceding taxation years.

This amendment applies to taxation years that begin after February 2000 except that, for corporations whose first taxation year that begins after February 2000 ends before 2001, this amendment applies to taxation years that begin after 2000.

## Clause 22

### Taxable Capital Gain and Allowable Capital Loss

ITA
38

Section 38 of the Act defines a taxpayer's taxable capital gain, allowable capital loss and business investment loss from the disposition of property as 3/4 of the taxpayer's capital gain, capital loss or business investment loss from the disposition. The section is amended as a consequence of the changes to the inclusion rates for capital gains and losses from 3/4 to 1/2.

ITA
38(*a*), (*b*) and (*c*)

(The commentary on paragraphs 38(*a*.1) and (*a*.2) follow this commentary.)

Paragraph 38(*a*) is also amended to add a reference to new paragraph 38(*a*.2), which provides that the inclusion rate in respect of qualifying gifts of ecologically sensitive land is 1/4.

These amendments are required in order to reflect the capital gains/losses inclusion rate for the year and apply to the 2000 and subsequent taxation years with the following exceptions.

For a taxation year of a taxpayer that ends before February 28, 2000, the references to the fraction "1/2" in paragraphs 38(*a*), (*b*) and (*c*) are to be read as references to the fraction "3/4".

For a taxation year of a taxpayer that begins after February 28, 2000 and ends before October 17, 2000, the references to the fraction "1/2" in paragraphs 38(*a*), (*b*) and (*c*) are to be read as references to the fraction "2/3".

For a taxation year of a taxpayer that includes February 28, 2000 but does not include October 18, 2000, the references to the fraction "1/2" in paragraphs 38(*a*), (*b*) and (*c*) are to be read as references to the fraction that applies to the taxpayer for that year, determined as follows:

- where the amount of the taxpayer's net capital gains from dispositions of property in the period that begins at the beginning of the year and ends at the end of February 27, 2000 (the first period) exceeds the amount of the taxpayer's net capital losses from dispositions of property in the period that begins at the beginning of February 28, 2000 and ends at the end of the year (the second period), the fraction that applies to the taxpayer for the year is 3/4;

- where the amount of the taxpayer's net capital losses from dispositions of property in the first period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the second period, the fraction that applies to the taxpayer for the year is 3/4;

- where the amount of the taxpayer's net capital gains from dispositions of property in the first period is less than the amount of the taxpayer's net capital losses from dispositions of property in the second period, the fraction that applies to the taxpayer for the year is 2/3;

- where the amount of the taxpayer's net capital losses from dispositions of property in the first period is less than the amount of the taxpayer's net capital gains from dispositions of property in the second period, the fraction that applies to the taxpayer for the year is 2/3;

- where the taxpayer has only net capital gains or only net capital losses from dispositions of property in each of both the first and second periods, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

$$(3/4\ A + 2/3\ B) / (A+B)$$

where

A is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in the first period, and

B is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in the second period; and

- where the net capital gains and net capital losses of the taxpayer for the year are nil, the fraction that applies to the taxpayer for the year is 2/3.

For a taxation year of a taxpayer that begins after February 27, 2000 and includes October 18, 2000, in order to determine the inclusion rate for the year the references to the fraction "1/2" in paragraphs 38(*a*), (*b*) and (*c*) are to be read as references to the fraction that applies to the taxpayer for that year, determined as follows:

- where the amount of the taxpayer's net capital gains from dispositions of property in the period that begins at the beginning of the year and ends at the end of October 17, 2000 (the first period) exceeds the amount of the taxpayer's net capital losses from dispositions of property in the period that begins at the beginning of October 18, 2000 and ends at the end of the year (the second period), the fraction that applies to the taxpayer for the year is 2/3;

- where the amount of the taxpayer's net capital losses from dispositions of property in the first period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the second period, the fraction that applies to the taxpayer for the year is 2/3;

- where the amount of the taxpayer's net capital gains from dispositions of property in the first period is less than the amount of the taxpayer's net capital losses from dispositions of property in the second period, the fraction that applies to the taxpayer for the year is 1/2;

- where the amount of the taxpayer's net capital losses from dispositions of property in the first period is less than the amount of the taxpayer's net capital gains from dispositions of property in the second period, the fraction that applies to the taxpayer for the year is 1/2;

- where the taxpayer has only net capital gains or only net capital losses from dispositions of property in each of both the first and second periods, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

(2/3 A + 1/2 B) / (A+B)

where

A is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in the first period, and

B is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in the second period and;

- where the net capital gains and net capital losses of the taxpayer for the year are nil, the fraction that applies to the taxpayer for the year is 1/2,

For a taxation year of a taxpayer that includes February 27, 2000 and October 18, 2000, in order to determine the inclusion rate for the year the references to the fraction "1/2" in paragraphs 38(*a*), (*b*) and (*c*) are to be read as references to the fraction that applies to the taxpayer for that year, determined as follows:

- where
  - the amount by which the taxpayer's net capital gains from dispositions of property in the period that begins at the beginning of the year and ends at the end of February 27, 2000 (the first period) exceeds the amount of the taxpayer's net capital losses from dispositions of property in the period that begins at the beginning of February 28, 2000 and ends at the end of October 17, 2000 (the second period)

  exceeds

  - the amount of the taxpayer's net capital losses from dispositions of property in the period that begins at the beginning of October 18, 2000 and ends at the end of the year (the third period),

  the fraction that applies to the taxpayer for the year is 3/4;

- where

  - the amount by which the taxpayer's net capital losses from dispositions of property in the first period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the second period

  exceeds

  - the amount of the taxpayer's net capital gains from dispositions of property in the third period

  the fraction that applies to the taxpayer for the year is 3/4;

- where

  - the amount by which the taxpayer's net capital gains from dispositions of property in the second period exceeds the amount of the taxpayer's net capital losses from dispositions of property in the first period

  exceeds

  - the amount of the taxpayer's net capital losses from dispositions of property in the third period

  the fraction that applies to the taxpayer for the year is 2/3;

- where

  - the amount by which the taxpayer's net capital losses from dispositions of property in the second period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the first period

  exceeds

  - the amount of the taxpayer's net capital gains from dispositions of property in the third period

  the fraction that applies to the taxpayer for the year is 2/3;

- where the taxpayer has net capital gains in the first and second periods and the aggregate of the amount of those net capital gains exceeds the amount of the taxpayer's net capital losses in the third period, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

  $$(3/4\ A + 2/3\ B) / (A+B)$$

  where

  A is the net capital gains of the taxpayer from dispositions of property in the first period, and

  B is the net capital gains of the taxpayer from dispositions of property in the second period;

- where the taxpayer has net capital losses in the first and second periods and the aggregate of the amount of those net capital losses exceeds the amount of the taxpayer's net capital gains in the third period, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

  $$(3/4\ A + 2/3\ B) / (A+B)$$

  where

  A is the net capital losses of the taxpayer from dispositions of property in the first period, and

  B is the net capital losses of the taxpayer from dispositions of property in the second period;

- where the taxpayer has only net gains, or only net capital losses, from dispositions of property in each the first, the second and the third periods, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

  $$(3/4\ A + 2/3\ B + 1/2C) / (A+B+C)$$

where

A is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in the first period,

B is the net capital gains or the net capital losses as the case may be, of the taxpayer from dispositions of property in the second period, and

C is the net capital gains or the net capital losses as the case may be, of the taxpayer from dispositions of property in the third period;

- where the amount of the taxpayer's net capital gains from dispositions of property in the first period exceeds the amount of the taxpayer's net capital losses from dispositions of property in the second period and the taxpayer has net capital gains from dispositions of property in the third period, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

$$(3/4\ A + 1/2\ B) / (A+B)$$

where

A is the amount by which the taxpayer's net capital gains from dispositions of property in the first period exceeds the amount of the taxpayer's net capital losses from dispositions of property in the second period, and

B is the taxpayer's net capital gains from dispositions of property in the third period;

- where the amount of the taxpayer's net capital losses from dispositions of property in the first period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the second period and the taxpayer has net capital losses from dispositions of property in the third period, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

$$(3/4\ A + 1/2\ B) / (A+B)$$

where

A is the amount by which the taxpayer's net capital losses from dispositions of property in the first period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the second period, and

B is the taxpayer's net capital losses from dispositions of property in the third period;

- where the amount of the taxpayer's net capital gains from dispositions of property in the second period exceeds the amount of the taxpayer's net capital losses from dispositions of property in the first period and the taxpayer has net capital gains from dispositions of property in the third period, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

$$(2/3\ A + 1/2\ B) / (A+B)$$

where

A is the amount by which the taxpayer's net capital gains from dispositions of property in the second period exceeds the amount of the taxpayer's net capital losses from dispositions of property in the first period, and

B is the taxpayer's net capital gains from dispositions of property in the third period;

- where the amount of the taxpayer's net capital losses from dispositions of property in the second period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the first period and the taxpayer has net capital losses from dispositions of property in the third period, the fraction that applies to the taxpayer for the year is the fraction determined by the formula

$$(2/3\ A + 1/2\ B) / (A+B)$$

where

A is the amount by which the taxpayer's net capital losses from dispositions of property in the second period exceeds the amount of the taxpayer's net capital gains from dispositions of property in the first period, and

B is the taxpayer's net capital losses from dispositions of property in the third period; and

- in any other case, the fraction that applies to the taxpayer for the year is 1/2.

For the purpose of determining the inclusion rate that applies to the taxpayer for the year, the following assumptions are to be made:

- The net capital gains of a taxpayer from dispositions of property in a period is the amount by which the taxpayer's capital gains from dispositions of property in the period exceeds the taxpayer's capital losses from dispositions of property in the period.

- The net capital losses of a taxpayer from dispositions of property in a period is the amount by which the taxpayer's capital losses from dispositions of property in the period exceeds the taxpayer's capital gains from dispositions of property in the period.

- The net amount included as a capital gain of the taxpayer for a taxation year from a disposition of ecological property or from a disposition to which paragraph 38(*a*.1) of the Act applies is one half of the capital gain.

- The net amount included as a capital gain of the taxpayer for a taxation year because of subparagraphs 40(1)(*a*)(ii) and (iii) of the Act is a capital gain of the taxpayer from a disposition of property on the first day of the year.

- Each capital loss that is a business investment loss is determined without reference to subsection 39(9) and 39(10) of the Act.

- Where an amount is included in computing the income of the taxpayer for the year because of subsection 80(13) of the Act in respect of a commercial obligation that is settled, the amount that would be determined under that subsection in respect of the obligation, if the value of E in the formula in that subsection were 1, is a capital gain of the taxpayer from a disposition of property on the day on which the settlement occurred.

- The taxpayer's capital gains and losses from dispositions of property (other than taxable Canadian property) that occur at a time when the taxpayer is a non-resident, are nil.

- Where an election is made by a taxpayer under amended paragraph 104(21.4)(*d*), new subsection 104(21.5) or subsections 130.1(4.3) or 131(1.6) of the Act for the year, the portion of the net capital gains of the taxpayer for the year that are to be treated as being in respect of capital gains realized on dispositions of property that occurred in a particular period in the year is that proportion of the net capital gains that the number of days in that period is of the number of days that are in the year.

- Where the election made under amended paragraph 104(21.4)(*d*) or new subsection 104(21.5) of the Act for the year was made by a personal trust, the portion of the taxpayer's net capital gains for the year that are to be treated as being in respect of capital gains realized on dispositions of property that occurred in a particular period in the year is that proportion of those net capital gains that the number of days in the particular period is of the number of days that are in all periods in the year in which a net gains was realized.

- Where, an amount is designated under subsection 104(21) of the Act in respect of a beneficiary by a trust and the trust does not elect under paragraph 104(21.4)(*d*) for the year, the deemed gains of the beneficiary referred to in subsection 104(21.4) are deemed to have been realized in each period in the year in a proportion that is equal to the same proportion that the net capital gains of the trust realized by the trust in that period is of all the net capital gains realized by the trust in the year.

- Where, in the course of administering the estate of a deceased taxpayer, a capital loss from disposition of property by the legal representative of a deceased taxpayer is deemed under paragraph 164(6)(*c*) of the Act to be a capital loss of the deceased taxpayer from the disposition of property by the taxpayer in the taxpayer's last taxation year and not to be capital losses of the estate, the capital loss is considered to be from the disposition of property by the taxpayer immediately before the taxpayer's death.

- Each capital gain referred to in amended paragraph 104(21.4)(*a*) of the Act in respect of a beneficiary, is to be determined as if that paragraph were read without reference to subparagraph (ii) thereof.

- Where no capital gains or losses are realized in a period, the amount of net capital gains or losses for that period is nil.

- Where a net amount is included as a capital gain of the taxpayer for a taxation year because of the granting of an option under subsection 49(1) of the Act, the net amount is a capital gain of the taxpayer from a disposition of property on the day on which the option was granted.

- Where a net amount is included as a capital gain of a corporation for its taxation year under subsection 49(2) of the Act because of the expiration of an option that was granted by the corporation, the net amount is a capital gain of the corporation from a disposition of property on the day on which the option expired.

- Where a net amount is included as a capital gain of a trust for its taxation year under subsection 49(2.1) of the Act because of the expiration of an option that was granted by the trust, the net amount is a capital gain of the trust from a disposition of property on the day on which the option expired.

- Where a net amount is included in respect of an option as a capital gain of a taxpayer for a taxation year because of subsection 49(3), 49(3.01) or 49(3.1) of the Act, the net amount is a capital gain of the taxpayer from a disposition of property on the day on which the option was exercised.

- Where an amount is included in the income of the taxpayer for the year because of property sold subject to an earn-out agreement, the taxpayer has a capital gain from a disposition of property on the day on which a payment was received under the agreement.

## Gift to Qualified Donee

ITA
38(*a*.1)

Paragraph 38(*a*.1) of the Act provides a special inclusion rate for capital gains arising as a result of a gift of certain securities to qualified donees. This inclusion rate is one half of the normal inclusion rate.

The amendment to paragraph 38(*a*.1) replaces the reference to the fraction "3/8" (one-half of 3/4) with a reference to the fraction "1/4" (one-half of 1/2).

The amendment applies to the 2000 and subsequent taxation years except that,

> (a) for a taxation year of a taxpayer that includes February 28, 2000 or October 17, 2000, the reference to the fraction "1/4" in paragraph 38(*a*.1) is to be read as a reference to 1/2 of the fraction in amended paragraph 38(*a*) that applies to the taxpayer for the year and,
>
> (b) for a taxation year that ends before February 28, 2000 the reference to the fraction "1/4" in paragraph 38(*a*.1) is to be read as a reference to the fraction "3/8".

## Ecological Gifts

ITA
38(*a*.2)

The portion of a taxpayer's capital gain that is required to be included in computing income is his or her "taxable capital gain". New paragraph 38(*a*.2) of the Act provides that if a capital gain results from the making of an ecological gift to a qualified donee, only 1/4 of the gain will be a taxable capital gain and hence included in income. The definitions of "ecological gifts" and "total ecological gifts" in paragraph 110.1(1)(*d*) and subsection 118.1(1) respectively are also amended to provide that the fair market value of such gifts must be certified by the Minister of the Environment. For further detail, see the commentary on section 118.1.

This amendment applies to gifts made after February 27, 2000, except that if the taxpayer's taxation year begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/4" is to be read as a reference to "1/3", and if the taxpayer's taxation year includes either February 28, 2000 or October 17, 2000, the capital gains inclusion rate will be one half of the rate otherwise calculated for the year under amended paragraph 38(*a*) of the Act.

## Clause 23

### Deduction from Business Investment Loss

ITA
39(9)(*b*)(i) to (i.2)

Pursuant to subsection 39(9) of the Act, in computing a business investment loss a taxpayer is required to deduct, from the amount of the business investment loss otherwise determined, the lesser of the amount of the business investment loss and the taxpayer's net capital gains for which a deduction was claimed under section 110.6 of the Act, to the extent that such gains have not been used to reduce other business investment losses.

In calculating the net capital gains for which a deduction was claimed under section 110.6, such deductions are grossed-up by the reciprocal of the applicable inclusion rate.

Consequential to the change of the inclusion rate for capital gains from 3/4 to 1/2, subparagraphs 39(9)(*b*)(i) to (i.2) are amended to provide for a reduction in a business investment loss of

- twice the amounts deducted by the taxpayer under section 110.6 for taxation years that ended prior to 1988 or begin after October 17, 2000,

- 3/2 of such amounts deducted for 1988, 1989 and taxation years that begin after February 27, 2000 and end before October 18, 2000,

- 4/3 of such amounts deducted for taxation years that ended after 1989 and before February 28, 2000, and

- an amount equal to the product obtained when the reciprocal of the taxpayer's inclusion rate (the fraction in amended paragraph 38(*a*) that applies to the taxpayer) for each of the taxpayer's taxation years that include February 28, 2000, or October 18, 2000 is multiplied by amounts deducted under section 110.6 for that taxation year.

These amendments apply to taxation years that end after February 27, 2000.

ITA
39(10)(*b*)(i) to (i.2)

Pursuant to subsection 39(10) of the Act, in computing a business investment loss of a trust, the trust is required to deduct from the amount of the business investment loss otherwise determined, the lesser of

- the amount of the business investment loss, and

- the amount by which the trust's capital gains exceeds capital losses (net gains) – to the extent that the net taxable capital gains derived from those net gains were the subject of a designation under subsection 104(21.2) of the Act in respect of a beneficiary and those net gains have not been used to reduce other business investment losses.

In calculating the net gains required to reduce the business investment loss, amounts designated in respect of beneficiaries under subsection 104(21.2) are grossed-up by the reciprocal of the applicable inclusion rate (the fraction that applies to the trust in amended paragraph 38(*a*)) of the trust.

Consequential to the change of the inclusion rate for capital gains from 3/4 to 1/2, subparagraphs 39(10)(*b*)(i) to (i.2) are amended to provide for a reduction in a business investment loss of a trust of

- twice the amounts designated by the trust under subsection 104(21.2) for taxation years that ended prior to 1988 and begin after October 17, 2000,
- 3/2 of such amounts designated for 1988, 1989 and taxation years that begin after February 27, 2000 and end before October 18, 2000,
- 4/3 of such amounts designated for taxation years that ended after 1989 and before February 28, 2000, and
- an amount equal to the product obtained when the reciprocal of the trust inclusion rate (for each of the trust's taxation years that include February 28, 2000 or October 18, 2000) is multiplied by the amounts designated by the trust under subsection 104(21.2) in respect of a beneficiary for that taxation year.

These amendments apply to taxation years that end after February 27, 2000.

### Recovery of Bad Debt

ITA
39(11)

Subsection 39(11) of the Act deems a portion of a recovered bad debt in respect of eligible capital property to be a taxable capital gain. The portion that is deemed to be a taxable capital gain is the amount that relates to the portion of the bad debt that was previously deemed by subsection 20(4.2) (now by subsection 20(4.3) of the Act) to be an allowable capital loss. For further detail, see the commentary to subsections 20(4.2) and (4.3).

Subsection 39(11) is amended consequential to the change to the inclusion rate for capital gains, by replacing the fraction "3/4" with the fraction "1/2".

This amendment applies in respect of taxation years that end after February 27, 2000 except that, for taxation years that end after February 27, 2000 and before October 18, 2000, the fraction to be used in calculating the deemed taxable capital gain is 2/3 rather than 1/2.

## Clause 24

## Exempt Capital Gains Balance in Respect of Flow-Through Entity

### Definitions

ITA
39.1(1) "exempt capital gains balance"

The exempt capital gains balance of an individual for a taxation year in respect of a flow-through entity represents the unclaimed balance of the capital gains that were included in computing the individual's income as a result of an election made under subsection 110.6(19) of the Act to crystallize accrued capital gains in respect of the individual's interest in or shares of the capital stock of the entity.

Where an election is made under subsection 110.6(19), the amount of the gain realized as a result of the election does not affect the adjusted cost base of the property but is instead credited to the exempt capital gains balance account of the taxpayer in respect of the taxpayer's interest in or share of the flow-through entity.

The description of C of the formula in the definition "exempt capital gains balance" in subsection 39.1(1) represents the total of amounts deducted in previous taxation years in respect of capital gains flowed out to the taxpayer from the flow-through entity which had been sheltered under any of subsections 39.1(3) through (5).

The amendments to the description of C in the definition are consequential to the change in the capital gains inclusion rate from 3/4 to 1/2.

Amended paragraph (*a*) of the description of C in the definition "exempt capital gains balance" requires a reduction of a taxpayer's exempt capital gains balance in respect of a trust by

- 3/2 of the amount by which taxable capital gains from a designation under subsection 104(21) of the Act in respect of the taxpayer were reduced under subsection 39.1(3) for taxation years that began after February 27, 2000 and ended before October 18, 2000,
- 4/3 of the amounts by which taxable capital gains from a designation under subsection 104(21) in respect of the taxpayer were reduced under subsection 39.1(3) for taxation years that ended before February 27, 2000,
- the amount claimed by the individual for a preceding taxation year under amended subparagraph 104(21.4)(*a*)(ii), and
- twice the total of all amounts each of which is the amount by which the individual's taxable capital gain (determined without reference to section 39), for a preceding taxation year that began after October 17, 2000 that resulted from a designation made under subsection 104(21) by the trust was reduced by reason of subsection 39.1(3) in the taxation year.

Amended paragraph (*b*) of the description of C in the definition "exempt capital gains balance" requires a reduction in a taxpayer's exempt capital gains balance in respect of a partnership by

- 3/2 of the amount by which the taxpayer's share of taxable capital gains and income of the partnership were reduced under subsections 39.1(4) and (5) for taxation years that began after February 27, 2000 and ended before October 18, 2000,
- 4/3 of the amount by which the taxpayer's share of taxable capital gains and income of the partnership were reduced under subsections 39.1(4) and (5) for taxation years that ended before February 28, 2000, and
- the product obtained when the reciprocal of the fraction in amended paragraph 38(*a*) that applies to the partnership for the fiscal period of the partnership that includes either

February 28, 2000 or October 17, 2000 is multiplied by the total of all amounts by which the taxpayer's share of taxable capital gains and income from the partnership were reduced under subsections 39.1(4) and (5) in the taxation year.

These amendments apply to taxation years that end after February 27, 2000.

### Reduction of Capital Gain

ITA
39.1(2)

Subsection 39.1(2) of the Act allows an individual with an exempt capital gains balance in respect of a flow through entity to claim a reduction in the capital gain otherwise determined for a taxation year from a subsequent disposition of an interest in or share of the capital stock of the flow-through entity. The reduction is limited to the individual's exempt capital gains balance for the year in respect of the entity.

Paragraphs (*a*) and (*b*) of the description of B in subsection 39.1(2) are amended to replace the reference to the expression "4/3 of" with a reference to the word "twice". The amendment is consequential to the reduction in the capital gains inclusion rate from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, where the taxation year of an entity that ends in the taxation year of the taxpayer includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the references to the word "twice" in paragraphs (*a*) and (*b*) of the description of B in subsection 39.1(2) are to be read as references to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the entity for its taxation year that ends in the taxpayer's taxation year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Reduction of Taxable Capital Gain

ITA
39.1(3)

Subsection 104(21) of the Act provides a flow-through mechanism for taxable capital gains of trusts. Where a trust makes a designation under that subsection in respect of a beneficiary, the designated amount is treated as a taxable capital gain of the beneficiary.

Subsection 39.1(3) of the Act allows an individual to claim a reduction in the amount of the taxpayer's taxable capital gain otherwise determined for a taxation year as a result of a designation under subsection 104(21) by a flow-through entity. The reduction is limited to 3/4 of the individual's exempt capital gains balance for the year in respect of the entity.

Subsection 39.1(3) is amended to replace the reference to the fraction "3/4" with a reference to the fraction "1/2". The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, where the taxation year of an entity that ends in the taxation year of the taxpayer includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference in the subsection 39.1(3) to that fraction is to be read as a reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the entity for its taxation year that ends in the taxpayer's taxation year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Reduction in Share of Partnership's Taxable Capital Gains

ITA
39.1(4)

A member of a partnership is taxed on his or her share of the income of the partnership for its fiscal period that ends in the member's taxation year. For this purpose, taxable capital gains at the partnership level are treated as taxable capital gains of its members to the extent of their respective shares thereof. Subsection 39.1(4) of the Act allows an individual to claim a reduction in the individual's share of a partnership's taxable capital gains for a fiscal period that ends in the individual's taxation year. The reduction is limited to 3/4 of the individual's exempt capital gains balance for the year in respect of the partnership.

As a consequence of the reduction of the inclusion rate for capital gains from 3/4 to 1/2, the fraction "3/4" in the description of A in subsection 39.1(4) is replaced by the fraction "1/2".

The amendment applies to taxation years that end after February 27, 2000 except that, where the taxation year of an entity that ends in the taxation year of a taxpayer includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the entity for its taxation year that ends in the taxpayer's taxation year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Reduction in Share of Partnership's Income from a Business

ITA
39.1(5)(*a*)

Subsection 39.1(5) of the Act allows an individual who is a member of a partnership to shelter, with his or her exempt capital gains balance in respect of the partnership, that part of his or her share of the partnership's income from a business that is attributable to an amount included under subparagraph 14(1)(*a*)(v) of the Act in computing the partnership's income from the business.

Subsection 39.1(5) is amended to replace the fraction "3/4" with the fraction "1/2" and to replace the reference to subparagraph 14(1)(*a*)(v) with a reference to paragraph 14(1)(*b*). The first amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2. The second amendment is consequential to the amendments to subsection 14(1).

These amendments apply to taxation years that end after February 27, 2000 except that, where the taxation year of an entity that ends in a taxpayer's taxation year includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" in subsection 39.1(5) is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the entity for its taxation year that ends in the taxpayer's taxation year. Further, in such circumstances amended subparagraph 39.1(5)(*a*)(i) is to be read as "(i) the amount, if any, claimed under subsection (4) by the individual for the year in respect of the partnership multiplied by the fraction obtained when the fraction in paragraph 14(1)(*b*) applicable to the entity for its taxation year that ends in the taxpayer's taxation year is divided by the fraction in paragraph 38(*a*) that applies to the entity for that taxation year". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Clause 25

### Gains and Losses – General Rules

ITA
40

Section 40 of the Act provides rules for determining a taxpayer's gain or loss from the disposition of a property.

### Limitations

ITA
40(2)(*g*)(iv)(A)

Paragraph 40(2)(*g*) of the Act denies the recognition of losses arising from certain dispositions, including dispositions by a taxpayer to a trust governed by a deferred profit sharing plan, employees profit sharing plan or registered retirement income fund, under which the taxpayer is a beneficiary.

Clause 40(2)(*g*)(iv)(A) is amended to replace a cross-reference to such trusts with a description of them. This amendment is consequential to the replacement of the definition "disposition" in section 54 with a new definition of the same expression in subsection 248(1).

This amendment applies to the 1998 and subsequent taxation years.

**Limited Partner**

ITA
40(3.14)

Subsection 40(3.14) of the Act provides an extended definition of "limited partner" for the purpose of determining whether a member's interest in a partnership is subject to the negative adjusted cost base rule in subsection 40(3.1).

Paragraph 40(3.14)(*a*) provides that a member of a partnership is a "limited partner" if, by operation of any law governing the partnership arrangement, the liability of the member as a member of the partnership is limited (e.g., a limited partner of a limited partnership). Concern has been expressed that paragraph 40(3.14)(*a*) applies to a partner of a "limited liability partnership" in addition to a limited partner of a limited partnership. A limited liability partnership is a new type of partnership the form of which has only recently been permitted under some provincial statutes.

Unlike a limited partner of a limited partnership, a member of limited liability partnership can be liable for the general debts and obligations of a limited liability partnership. However, a member of a limited liability partnership is not liable for the debts, obligations and liabilities of the partnership, or any member of the partnership, arising from negligent acts or omissions that another member of the partnership or an employee, agent or representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership.

Paragraph 40(3.14)(*a*) is amended to exclude from its application cases where a member's liability is limited by operation of a statutory provision of Canada or a province that limits the member's liability only for the debts, obligations and liabilities of a limited liability partnership, or any member of the partnership, arising from negligent acts or omissions that another member of the partnership or an employee, agent or representative of the partnership commits in the course of the partnership business and while the partnership is a limited liability partnership.

This amendment applies after 1997.

## Losses of Former Resident

ITA
40(3.7)

New subsection 40(3.7) of the Act is a "stop-loss" rule that may reduce the loss of an individual from the disposition of a property if the individual disposes of the property at any time after having ceased to be resident in Canada. In general terms, this stop-loss rule applies where an individual has received dividends in respect of a property (whether a share, an interest in a partnership or an interest in a trust) during the period of non-residence that begins after the individual last acquired the property.

The Act already includes, in section 112 and related provisions, a comprehensive stop-loss system for corporations. Instead of duplicating that system, new subsection 40(3.7) adapts it to apply to losses otherwise realized by individuals on dispositions of property after they ceased to be resident in Canada, regardless of whether they are resident in Canada at the time of such dispositions.

For the purposes of applying subsections 100(4), 107(1) and 112(3) to (3.32) and (7) of the Act, new subsection 40(3.7) deems an individual to be a corporation in respect of dividends received in respect of a property after the last time the individual acquired the property and while the individual was non-resident, and deems any taxable dividends received by the individual during that period to have been deductible under section 112 when received. The effect of this is that some or all dividends received while non-resident may reduce the individual's loss on a share, partnership interest or trust interest.

New subsection 40(3.7) applies to dispositions of property that occur after December 23, 1998 by individuals who cease to be resident in Canada after October 1, 1996.

### Additions to Taxable Canadian Property

ITA
40(9)

As a result of changes to the definition of "taxable Canadian property," certain properties acquired before April 27, 1995 became taxable Canadian properties on that date. Subsection 40(9) was enacted to provide rules for computing a non-resident person's gain or loss from the disposition of such a property, prorating the amount of gain or loss determined without reference to the subsection according to the number of months the person held the property before May 1995.

Effective October 2, 1996 the definition of "taxable Canadian property" is again amended so that certain properties acquired before that date will have become taxable Canadian properties on that date. Subsection 40(9) is amended to clarify that the formula it sets out applies only to gains or losses realized on the disposition of properties that became taxable Canadian properties on April 27, 1995.

Amended subsection 40(9) applies to dispositions that occur after April 26, 1995.

## Clause 26

### Taxable Net Gain from Disposition of Listed Personal Property

ITA
41(1)

Subsection 41(1) of the Act defines a taxpayer's taxable net gain for a taxation year from dispositions of listed personal property as 3/4 of the taxpayer's net gain determined under subsection 41(2) from dispositions of such property.

Subsection 41(1) is amended to replace the reference to the fraction "3/4" with a reference to the fraction "1/2". The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxpayer's taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" in subsection 41(1) is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Clause 27

### Part Dispositions

ITA
43

Section 43 of the Act is a rule governing the disposition of a part of a property. For the purpose of computing a taxpayer's gain or loss from the disposition of a part of a property, a portion of the adjusted cost base (ACB) of the whole property must be allocated to the part on a reasonable basis.

ITA
43(1)

Existing section 43 is renumbered as subsection 43(1) as a consequence of the introduction of new subsections 43(2) and (3). This amendment applies after February 27, 1995.

### Ecological Gifts

ITA
43(2)

New subsection 43(2) of the Act applies where the part of a property disposed of is a servitude, covenant or easement to which land is subject. The 1995 budget introduced enhanced incentives for the donation of ecologically sensitive land to the Government of Canada, a provincial government, a Canadian municipality or an approved registered charity established for the purpose of protecting Canada's environmental heritage. Donations from individuals are eligible for the charitable donations tax credit (section 118.1 of the Act), while those from corporations are deductible in computing income (section 110.1 of the Act). Besides transfers of title, landowners are able to donate covenants, easements and servitudes established under common law, the civil law of the province of Quebec, or the law of other provinces allowing for their establishment.

Normally the value of a donated property is determined to be the price that a purchaser would pay for the property on the open market. As there is no established market for covenants, easements and servitudes, the fair market value of such restrictions on land use is difficult to determine. To provide greater certainty in making these valuations, the 1997 budget introduced a measure to deem the value of these gifts to be not less than the resulting decrease in the value of the land. That measure was implemented with application to gifts made after February 27, 1995.

Like other capital property, the adjusted cost base (ACB) of a covenant, easement or servitude is also relevant in calculating the capital gain or loss that may arise on disposition. To provide taxpayers greater certainty in making this calculation, new subsection 43(2) ensures that a portion of the ACB of the land to which the covenant, easement or servitude relates is to be allocated to the donated covenant, easement or servitude. For this purpose, the allocation of the ACB of the land to the gift is calculated in proportion to the percentage decrease in the value of the land as a result of the donation.

This amendment applies in respect of gifts made after February 27, 1995.

**Payments out of Trust Income, etc.**

ITA
43(3)

New subsection 43(3) applies where part of a capital interest in a trust would, but for paragraph (*h*) or (*i*) of the definition "disposition" in subsection 248(1), be disposed of solely because of a satisfaction by the trust of a right to enforce a payment from the trust. No portion of the ACB of the taxpayer's capital interest is allocated to such a right. Accordingly, the ACB to the taxpayer of the remaining part of the taxpayer's capital interest in the trust is not reduced after the satisfaction of such a right. This amendment applies to satisfactions of rights that occur after 1999.

***Example***

*Joseph buys 1,000 units of XYZ Mutual Fund on December 23, 2000 for $10,000. XYZ has not made an election under subsection 132.11(1) to have a December 15 year end. XYZ makes $400 of its income for its 2000 taxation year payable to Joseph on December 31, 2000. However, without making any cash distribution of the income, XYZ issues 42 additional units on that date in satisfaction of the $400 of income payable. In November 2001, Joseph disposes of his 1,042 units for $10,700.*

*Results:*

*1. Under subsection 104(13), Joseph is required to include $400 in computing his income for the 2000 taxation year.*

*2. The right to enforce the payment of the distribution is treated as part of Joseph's capital interest in the trust under subsection 108(1). However, under paragraphs (h) and (i) of the definition "disposition" in subsection 248(1), there is no disposition of that part of the capital interest on the satisfaction of the right.*

*3. Under subsection 43(3), no part of the ACB of the original interest is allocated to the right to the income payable when the right is satisfied. Without taking into account the identical properties rule in subsection 47(1), this ensures that the ACB of Joseph's original 1,000 units will remain $10,000 once the right to income is satisfied, notwithstanding that Joseph acquired the units late in the 2000 taxation year.*

*4. The 42 additional units issued in satisfaction of the right to income are acquired at a cost of $400 because new subsection 248(25.3) ensures that the cost of the units issued directly in satisfaction of the income payable is equal to that amount. Consequently, the total ACB of the 1,042 units at the time of the disposition is $10,400.*

*5. Consequently, the capital gain realized on the subsequent disposition of all of the units is $300.*

The introduction of subsection 43(3) is part of a set of amendments designed to clarify the tax consequences of distributions from trusts to their beneficiaries after 1999. For the large part, the end results achieved under these rules accord with existing income tax practice. Other related amendments include the repeal of subsection 52(6), amendments to subsections 107(2) and (2.1), the amended definition "capital interest" in subsection 108(1), paragraphs (*d*), (*h*) and (*i*) of the definition "disposition" in subsection 248(1) and new subsections 248(25.3) and (25.4). For further detail, see the commentary on those provisions.

## Clause 28

### Exchanges of Property

ITA
44(1)

Section 44 of the Act allows a taxpayer to defer in certain circumstances the recognition of a capital gain in respect of property.

Subsection 44(1) of the Act allows a taxpayer who incurs a capital gain on the disposition of certain capital property to defer tax on the gain to the extent that the taxpayer reinvests the proceeds in a replacement property within a certain period of time.

Subsection 44(1) is amended to provide that the replacement property provisions do not apply to shares of the capital stock of a corporation. These amendments apply to shares disposed of after April 15, 1999, subject to transitional relief for shares disposed of after that day as a consequence of a public takeover bid filed with a public authority before April 16, 1999.

## Clause 29

### Capital Gains Deferral – Eligible Small Business Investments

ITA
44.1

New section 44.1 of the Act permits an individual to defer, in certain circumstances, the recognition for income tax purposes of all or a portion of a capital gain arising on a disposition of an eligible small business investment.

This new section applies to dispositions that occur after February 27, 2000.

### Definitions

ITA
44.1(1)

New subsection 44.1(1) of the Act defines terms used in section 44.1.

"ACB reduction"

The term "ACB reduction" is relevant for the purpose of new paragraph 44.1(2)(*b*). An individual's ACB reduction in respect of a replacement share of an individual in respect of a qualifying disposition is determined as that proportion of the permitted deferral of the individual in respect of the qualifying disposition that the qualifying cost to the individual of the replacement share is of the qualifying cost to the individual of all replacement shares. The ACB reduction reduces the adjusted cost base to the individual of the replacement share under paragraph 44.1(2)(*b*) and subparagraph 53(2)(*a*)(v) of the Act.

"active business corporation"

The term "active business corporation" is relevant for the purposes of the term "qualifying disposition" and new subsection 44.1(6). An active business corporation at any time is a taxable Canadian corporation all or substantially all of the fair market value of the assets of which, at that time, is attributable to assets of the corporation that are

- used principally in an active business carried on by the corporation or by an active business corporation related to it,

- shares or debt of other active business corporations related to the corporation, or

- a combination of those types of assets.

Pursuant to new subsection 44.1(10), a professional corporation, a specified financial institution, a corporation that the principal business of which is the leasing, rental, development or sale or any combination thereof of real property owned by it, or a corporation that more than 50 per cent of the fair market value of the property of which is attributable to real property are excluded from this definition.

"carrying value"

The term "carrying value" is relevant for the purpose of the term "eligible small business corporation share". The carrying value of the assets of a corporation at any time is the amount at which its assets would be valued for the purpose of its balance sheet if that balance sheet were prepared in accordance with generally accepted accounting principles used in Canada. An exception is that an asset of the corporation that is a share or a debt issued by a related corporation is deemed to have a carrying value of nil.

"common share"

The term "common share" is relevant for the purposes of the definition "eligible small business corporation share" and new subsection 44.1(7) of the Act. A common share is a share prescribed by subsection 6204(1) of the *Income Tax Regulations* for the purpose of paragraph 110(1)(*d*) of the Act.

"eligible pooling arrangement"

The term "eligible pooling arrangement" is relevant for the purpose of new subsection 44.1(3) of the Act. An eligible pooling arrangement is an agreement in writing made between an individual and another person or partnership (the investment manager) where the terms and conditions of the agreement provide

- for the transfer of funds or other property by the individual to the investment manager,
- the use of the funds or proceeds from the sale of the property by the investment manager to purchase eligible small business corporation shares on behalf of the individual within 60 days of the receipt of the funds or property, and
- a monthly reporting to the individual by the investment manager of the securities transactions made on behalf of the individual.

"eligible small business corporation"

The term "eligible small business corporation" is relevant for the purpose of the term "eligible small business corporation share". An eligible small business corporation, at a particular time, means a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which is, at that time, attributable to assets of the corporation that are

- assets used principally in an active business carried on primarily in Canada by the corporation or an eligible small business corporation related to it,
- shares of or debt issued by other eligible small business corporations related to the corporation, or
- a combination of those two types of assets.

An exception is that an asset of the corporation that is a share or a debt issued by a related corporation is deemed to have a carrying value of nil.

"eligible small business corporation share"

The term "eligible small business corporation share" of an individual is relevant for the purposes of the term "qualifying disposition" of an individual and new subsections 44.1(6) and (7) of the Act. An eligible small business corporation share of an individual is a common share issued by a corporation to the individual where at the time the share is issued the corporation was an eligible small business corporation and immediately before and after that time the total carrying value of its assets and the assets of corporations related to it does not exceed $50 million.

"permitted deferral"

An individual's "permitted deferral" in respect of a qualifying disposition is the amount of a capital gain from the disposition that can be deferred. It reduces the gain otherwise determined of the individual for the qualifying disposition. It is determined as that portion of the qualifying portion of the capital gain of the individual from a qualifying disposition of the individual that the total of the qualifying cost to the individual of replacement shares in respect of the disposition is of the qualifying proceeds of disposition of the individual in respect of the disposition.

"qualifying cost"

The term "qualifying cost" of an individual of replacement shares of the individual in respect of a particular qualifying disposition of the individual is relevant in computing the individual's permitted deferral in respect of the qualifying disposition. The qualifying cost is the lesser of two amounts. The first is the cost of the replacement shares issued by the particular eligible small business corporation. The second is the amount by which $2,000,000 exceeds the total of the cost of all other replacement shares in respect of other qualifying dispositions of the individual at or before the time of the qualifying disposition that were shares of the particular eligible small business corporation or an eligible small business corporation related to it at the time the share was acquired.

"qualifying disposition"

The term "qualifying disposition" of an individual is relevant for the purposes of the term "permitted deferral" and subsection 44.1(2) of the Act. An individual can have a capital gain deferral only in respect a gain arising on a qualifying disposition of the individual. A qualifying disposition of an individual is a disposition of common shares of the capital stock of a corporation owned by the individual where each such share was an eligible small business corporation share of the individual, was a common share of the capital stock of an active business corporation throughout the time it was owned by the individual and was owned by the individual throughout the 185-day period that ended immediately before the disposition. Pursuant to new subsection 44.1(9), the active business of the corporation referred to in the definition "active business corporation" has to be carried on primarily in Canada, at all times in the period that began when the individual last acquired the share and ended when the disposition occurred (the "ownership period"), if that period is less than 730 days. In any other case that active business has to be carried on primarily in Canada for at least 730 days during the ownership period.

"qualifying portion of a capital gain"

The term "qualifying portion of a capital gain" of an individual from a qualifying disposition of the individual is relevant for the purpose of the term "permitted deferral". An individual's portion of a capital gain from a particular qualifying disposition of shares of the capital stock of a particular eligible small business corporation is determined as that proportion of the capital gain (determined without reference to section 44.1) of the individual from that disposition that can be attributed to the amount of adjusted cost base of shares disposed of that does not exceed the $2,000,000 investment limit. This amount of adjusted cost base is determined by reference to the adjusted cost bases of shares (determined without reference to new section 44.1) of the particular corporation or corporations related to it disposed of in qualifying dispositions of the individual at or before the time of the particular qualifying disposition.

For example, if the individual had a capital gain from a particular qualifying disposition in which the individual sold shares with a total adjusted cost base of $3,000,000, because of the $2,000,000 investment limit, only 2/3 of the gain otherwise determined would be included in the qualifying portion of the capital gain.

"qualifying portion of the proceeds of disposition"

The term "qualifying portion of the proceeds of disposition" of an individual from a qualifying disposition is relevant for the purposes of the term "permitted deferral". It is determined by multiplying the individual's proceeds of disposition by the fraction that is determined by dividing the individual's qualifying portion of the capital gain from the disposition by the individual's capital gain from the disposition determined without reference to section 44.1. The individual's qualifying portion of the proceeds of disposition represents the maximum amount that the individual can include as the qualifying cost of replacement shares when calculating the permitted deferral of the individual in respect of the qualifying disposition.

"replacement share"

The term "replacement share" of an individual is relevant for the purpose of the term "permitted deferral". A replacement share of an individual in respect of a particular qualifying disposition of the individual in a taxation year means an eligible small business corporation share that was designated by the individual in the individual's return of income to be a replacement share of the individual in respect of the qualifying disposition and that was acquired by the individual within the year or within 60 days after the year but no later than 120 days after the qualifying disposition.

## Capital Gain Deferral

ITA
44.1(2)

New subsection 44.1(2) of the Act permits an individual that has a capital gain, determined without reference to section 44.1, from a qualifying disposition in a taxation year to claim the permitted deferral of the individual in determining the individual's capital gain for the year from the disposition. Where the individual has a permitted deferral in respect of a qualifying disposition, the capital gain from the disposition is deemed to be the amount by which the individual's capital gain (determined without reference to section 44.1) exceeds the permitted deferral. The individual can establish a permitted deferral less than the maximum amount available by designating a lesser amount of replacement shares.

Under the subsection, the adjusted cost base to the individual, determined without reference to section 44.1, of the replacement shares of the individual in respect of the disposition is reduced by the amount of the individual's ACB reduction in respect of such replacement shares.

### Special Rule – Eligible Pooling Arrangements

ITA
44.1(3)

New subsection 44.1(3) of the Act provides that any transaction entered into by an investment manager on behalf of an individual under an eligible pooling arrangement is deemed to be a transaction of the individual and not a transaction of the investment manager, except for the purpose of the definition "eligible pooling arrangement".

### Special Rule – Acquisitions on Death

ITA
44.1(4)

New subsection 44.1(4) of the Act provides a special rule in cases where eligible small business corporation shares are acquired by an individual as a consequence of the death of a person who is a spouse, common-law partner or a parent of the individual. Where subsection 70(6) or 70(9.2) of the Act applies to the individual in respect of such shares, the individual shall, for the purposes of section 44.1, be deemed to have acquired and owned the shares when they were acquired and owned by the spouse, common-law partner or parent. This rule permits the individual to be in the same position to claim a permitted deferral as the spouse, common-law partner or parent in respect of a capital gain arising on the disposition of such shares.

### Special Rule – Breakdown of Relationships

ITA
44.1(5)

New subsection 44.1(5) of the Act provides a special rule in cases where eligible small business corporation shares of a former spouse or common-law partner of an individual are acquired by the individual as the consequence of the settlement of rights arising out of their marriage or common-law partnership. Where subsection

73(1) applied to the individual in respect of such shares, the individual is, for the purposes of section 44.1, deemed to have acquired and owned the shares when they were acquired and owned by the former spouse or common-law partner. This rule puts the individual in the same position to claim a permitted deferral as the former spouse or common-law partner in respect of a capital gain arising on the disposition of such shares.

## Special Rule – Eligible Small Business Corporation Share Exchanges

ITA
44.1(6)

New subsection 44.1(6) of the Act provides special rules where an individual exchanges an eligible small business corporation share for new eligible small business corporation shares and the only consideration received on the exchange is the new eligible small business corporation shares. Where the individual's proceeds of disposition of the exchanged shares equals the adjusted cost base to the individual of the exchanged shares and paragraph 85(1)(*h*) or subsection 85.1(3) or 87(4) of the Act applies to the individual in respect of the new shares, the new shares are deemed to have been owned by the individual throughout the period that the exchanged shares were owned by the individual. The individual's eligibility to claim a permitted deferral with respect to a gain arising on a disposition of the exchanged shares is rolled over to new shares.

## Special Rule – Active Business Corporation Share Exchanges

ITA
44.1(7)

New subsection 44.1(7) of the Act provides special rules where an individual, in a qualifying disposition, disposes of common shares of an active business corporation for consideration consisting only of new common shares of another active business corporation issued to the individual. Where the individual's proceeds of disposition for the exchanged shares equals the individual's adjusted cost base of those shares and paragraph 85(1)(*h*) or subsection 85.1(3) or 87(4) of the Act applies to the individual in respect of the new shares, the new shares are deemed to be eligible small business shares of the individual that were owned by the individual throughout the period that the exchanged shares were owned by the individual and the new shares are deemed to be shares of an active business corporation that were owned by the individual throughout the period that the exchanged shares were owned by the individual. In effect, the individual's eligibility to claim a permitted deferral with respect to a capital gain arising on a disposition of the exchanged shares is rolled over to new shares.

**Special Rule – Carrying On an Active Business**

ITA
44.1(8)

New subsection 44.1(8) of the Act is relevant in determining whether a property held by a corporation is considered to be used or held in the course of carrying on an active business (active business property). Property held by a corporation at any particular time will be treated as active business property where that property or property for which that property is substituted property (special purpose property) was acquired by the corporation because it issued a debt or a share of a class of its capital stock, it disposed of property used or held in the course of carrying on an active business or it accumulated its active business earnings in order to acquire money for the purpose of acquiring property to be used in or held in the course of or making expenditures for the purpose of earning income from an active business carried on by the corporation. This rule will apply only where the corporation carries on an active business and the property was acquired within 36 months after the particular time.

**Special Rule – Qualifying Disposition**

ITA
44.1(9)

New subsection 44.1(9) of the Act is relevant in determining whether a disposition is a qualifying disposition. A disposition of a common share of an active business corporation by an individual that would otherwise be a qualifying disposition is deemed not to be a qualifying disposition unless the active business of the corporation referred to in paragraph (*a*) of the definition "active business corporation" was carried on primarily in Canada, at all times in the period that began when the individual last acquired the share and ended when the disposition occurred (the "ownership period"), if that period is less than 730 days. In any other case that active business has to be carried on primarily in Canada for at least 730 days during the ownership period.

### Special Rule – Exceptions

ITA
44.1(10)

New subsection 44.1(10) of the Act is relevant in determining whether a corporation can qualify as an eligible small business corporation or as an active business corporation. A professional corporation, a specified financial institution, a corporation the principal business of which is the leasing, rental, development of sale or any combination thereof of real property owned by it, or a corporation more than 50 per cent of the fair market value of the property of which is attributable to real property cannot qualify as an eligible small business corporation or as an active business corporation.

### Determination Rule

ITA
44.1(11)

New subsection 44.1(11) of the Act is relevant in determining whether a share is an eligible small business corporation share of an individual for the purpose of section 48.1 of the Act.

Section 48.1 permits a taxpayer, under certain circumstances, to elect to be treated as having disposed of a share and as having reacquired it at the same amount. Its purpose is to permit the individual to report an accrued gain on a small business share in respect of which the taxpayer would be eligible to claim a capital gains exemption under section 110.6 of the Act. The deemed reacquisition of the share under section 48.1 prevents the share from qualifying as an eligible small business corporation share of the individual because the share is not deemed to have been acquired from the corporation that issued the share.

New subsection 44.1(11) provides that in determining if a share is an eligible small business corporation, the Act is to be read without reference to section 48.1.

## Anti-Avoidance Rule

ITA
44.1(12)

New subsection 44.1(12) of the Act is an anti-avoidance rule. It applies where an individual or persons related to the individual dispose of shares of a particular corporation (which would normally result in the use of the corporate reorganisation rules or a return of paid-up capital of shares of the corporation) and acquire new shares of the particular corporation or a corporation that does not deal at arm's length with the particular corporation principally for the purpose of increasing the total amount of permitted deferrals with respect to qualifying dispositions of the individual and the related persons. Where the rule applies, the permitted deferral with respect to qualifying dispositions of the new shares is deemed to be nil.

For example, the rule will apply in cases where:

- a corporation reorganises its capital using section 86 of the Act in order to give its shareholders small business shares in exchange for its shares that did not qualify as small business shares in order to increase the amount of permitted deferrals in respect of qualifying dispositions of the shareholders;

- a corporate reorganisation is undertaken by a particular corporation principally in order to reduce the adjusted cost base of shares in order to increase the amount of permitted deferral of its shareholders with respect to qualifying dispositions of the shareholders;

- paid-up capital of shares of a particular corporation is returned to its shareholders followed by a subscription by the shareholders of shares issued by the particular corporation or a related corporation in order to increase the amount of permitted deferrals of the shareholders in respect of qualifying dispositions.

New section 44.1 applies to dispositions after February 27, 2000 except that, for dispositions made after February 27, 2000 and before October 18, 2000,

- the definition "active business corporation" in subsection 44.1(1) of the Act, is to be read without reference to the words "subject to subsection (10)" and as if the reference to the words "carried on" were read as reference to the words "carried on primarily in Canada",

- the definition "eligible small business corporation" in subsection 44.1(1) is to be read without reference to the words "subject to subsection (10)",

- the definition "eligible small business corporation share" in subsection 44.1(1), is to be read as;

  > "eligible small business corporation share" of an individual means a common share issued by a corporation to the individual if
  >
  > (a) at the time the share was issued, the corporation was an eligible small business corporation;
  >
  > (b) immediately before the share was issued, the total carrying value of the assets of the corporation and corporations related to it did not exceed $2,500,000; and
  >
  > (c) immediately after the share was issued, the total carrying value of the assets of the corporation and corporations related to it did not exceed $10,000,000,

- the definition "qualifying cost" in subsection 44.1(1), is to be read as if the reference to "$2,000,000" in subparagraph (*b*) thereof were read as a reference to "$500,000",

- the definition "qualifying disposition" in subsection 44.1(1), is to be read without reference to the words "subject to subsection (9)",

- the definition "qualifying portion of a capital gain" in subsection 44.1(1), is to be read as if the reference to "$2,000,000" in paragraph (*c*) in the description of K in that definition were read as a reference to "$500,000" and section 44.1, is to be read without reference to subsections (9) and (10) thereof, and

- section 44.1 is to be read without reference to subsections (9) and (10)

***Example 1***

*The following example demonstrates the determinations required under section 44.1 for dispositions after October 17, 2000.*

*Facts*

*An individual makes a qualifying disposition of shares of corporation A with an adjusted cost base of $3,000,000 for proceeds of disposition of $4,500,000.*

*The individual purchases replacement shares in corporations B with a cost of $2,200,000 and in corporation C with a cost of $2,300,000.*

*Determinations*

*The capital gain of the individual otherwise determined is $1,500,000 ($4,500,000 - $3,000,000).*

*The qualifying portion of the capital gain of the individual from the disposition is determined to be $1,000,000 by the formula J x (1-(K/L)) found in the definition of that expression in section 44.1(1) ($1,500,000 x (1- ($1,000,000/$3,000,000)) = $1,000,000) and represents the maximum amount of capital gain that can be deferred.*

*The qualifying portion of the proceeds of disposition of the individual from the disposition is determined to be $3,000,000 by the formula M x (N/O) found in the definition of that expression in section 44.1(1) ($4,500,000 x ($1,000,000/$1,500,000) = $3,000,000) and represents the maximum amount of replacement share investments that can be used to determined the maximum permitted deferral in respect of the disposition.*

*The qualifying cost (subject to the $2,000,000 limit per related group of corporations) of the replacement shares in corporation B is $2,000,000 and in corporation C is $2,000,000 for a total of $4,000,000.*

*The permitted deferral of the individual in respects of the disposition is determined to be $1,000,000 by the formula (G/H) x I found in the definition of that expression in section 44.1(1). (($3,000,000/$3,000,000) x $1,000,000 = $1,000,000.)*

*The capital gain from the disposition after deducting the permitted deferral in respect of the disposition is determined as $1,500,000 - $1,000,000 = $500,000.*

*The ACB reduction, which is determined by the formula D x (E/F) found in the definition of that expression in section 44.1(1), of the individual in respect of the replacement shares in corporation B is determined as ($1,000,000 x (2,000,000/$4,000,000) = $500,000) and in respect of the replacement shares in corporation C is determined as ($1,000,000 x (2,000,000/$4,000,000) = $500,000).*

*The adjusted cost base to the individual of the replacement shares in Corporation B is determined as ($2,2000,000 - $500,000 = $1,700,000) and of the replacement shares in corporation C ($2,300,000 - $500,000 = $1,800,000).*

***Example 2***

*The following example demonstrates the determinations required under section 44.1 for dispositions after February 27, 2000 and before October 18, 2000.*

*Facts*

*An individual makes a qualifying disposition of shares of corporation A with an adjusted cost base of $800,000 for proceeds of disposition of $1,600,000.*

*The individual purchases replacement shares in corporations B with a cost of $700,000 and in corporation C with a cost of $900,000.*

*Determinations*

*The capital gain of the individual otherwise determined is $800,000 ($1,600,000 - $800,000).*

*The qualifying portion of the capital gain of the individual from the disposition is determined to be $500,000 by the formula J x (1-(K/L)) found in the definition of that expression in section 44.1(1) ($800,000 x (1- ($300,000/$800,000)) = $500,000) and represents the maximum amount of capital gain that can be deferred.*

*The qualifying portion of the proceeds of disposition of the individual from the disposition is determined to be $1,000,000 by the formula M x (N/O) found in the definition of that expression in section 44.1(1) ($1,600,000 x ($500,000/$800,000) = $1,000,000) and represents the maximum amount of replacement share investments that can be used to determined the maximum permitted deferral in respect of the disposition.*

*The qualifying cost (subject to the $500,000 limit per related group of corporations) of the replacement shares in corporation B is $500,000 and in corporation C is $500,000 for a total of $1,000,000.*

*The permitted deferral of the individual in respects of the disposition is determined to be $500,000 by the formula (G/H) x I found in the definition of that expression in section 44.1(1) (($1,000,000/$1,000,000) x $500,000= $500,000).*

*The capital gain from the disposition after deducting the permitted deferral in respect of the disposition is determined as ($800,000 - $500,000 = $300,000).*

*The ACB reduction, which is determined by the formula D x (E/F) found in the definition of that expression in section 44.1(1), of the individual in respect of the replacement shares in corporation B is determined as ($500,000 x (500,000/$1,000,000) = $250,000) and in respect of the replacement shares in corporation C is determined as ($500,000 x (500,000/$1,000,000) = $250,000).*

*The adjusted cost base to the individual of the replacement shares in Corporation B is determined as ($7,000,000 - $250,000 = $450,000) and of the replacement shares in corporation C ($900,000 - $250,000 = $650,000).*

## Clause 30

### Change in Use

ITA
45(1)(*d*)

Subsection 45(1) of the Act provides for a deemed disposition and reacquisition of property where its use is altered, wholly or in part, from a personal to an income-earning or income-producing use, or vice versa. This "change in use" rule applies for the purpose of the subdivision of the Act that deals with taxable capital gains and allowable capital losses.

New paragraph 45(1)(*d*) provides that, in applying subsection 45(1) in respect of a non-resident taxpayer, any reference to "gaining or producing income" is to be read as a reference to gaining or producing income from a source in Canada. As a result, a non-resident who ceases to use a property to earn income in Canada and begins to use it instead to earn income outside Canada will be treated as having disposed of the property.

New paragraph 45(1)(*d*) applies after October 1, 1996.

## Clause 31

### Personal-Use property

ITA
46

Section 46 of the Act provides rules that apply to personal-use property (which is defined in section 54). The effect of these rules is to ensure that no gain or loss is recognized in respect of the first $1,000 of proceeds or cost of a personal-use property.

Subsection 46(2) provides related rules that apply where only part of a personal-use property is disposed of.

Subsections 46(1) and (2) are amended to exclude from their application "excluded property" that is disposed of in circumstances to which the charitable gift deduction in subsection 110.1(1) applies, or the definition "total charitable gifts", "total cultural gifts" or "total ecological gifts" in subsection 118.1(1) applies.

New subsection 46(5) defines excluded property of a taxpayer to mean, in general terms, property acquired by the taxpayer in circumstances in which it is reasonable to conclude that the acquisition relates to an arrangement, plan or scheme that is promoted by another person or partnership in circumstances where it is reasonable to conclude that the property will be the subject of a gift to which a charitable deduction or credit will be claimed under the Act.

These amendments apply to property acquired after February 27, 2000.

## Clause 32

### Identical Properties

ITA
47

Section 47 of the Act sets out rules that apply to identical properties for purposes of subdivision c of the Act, which deals with capital gains and capital losses on such properties.

### Securities Acquired by Employee

ITA
47(3)

Subsection 47(1) of the Act requires that the cost of identical properties acquired by a taxpayer be averaged over all such properties. Generally, this results in each of the properties having the same adjusted cost base (ACB), thus ensuring that the capital gain or loss on the disposition of any one of the properties can be determined without having to identify a particular property as the property that has been disposed of.

New subsection 47(3) exempts certain securities acquired after February 27, 2000 from the cost-averaging rule by deeming such securities not to be identical to any other securities acquired by the taxpayer for the purposes of subsection 47(1). The specific securities to which subsection 47(3) applies are as follows:

- Securities (i.e., shares of a corporation and units of a mutual fund trust) acquired under an employee option agreement for which a deferral is provided under existing subsection 7(1.1) or new subsection 7(8) of the Act, and securities acquired in exchange for such securities under circumstances to which subsection 7(1.5) of the Act applied.

- Securities acquired under an employee option agreement where the securities are designated by the taxpayer and deemed by new subsection 7(1.31) of the Act to be the securities that are the subject of a disposition of identical securities occurring within 30 days after the acquisition.

- Employer shares received by an employee as part of a lump sum payment on withdrawing from a deferred profit sharing plan (DPSP), where the employee filed an election in respect of those shares under subsection 147(10.1) of the Act. Such an election allows the taxpayer to defer taxation on the growth of the shares while they were held by the plan until such time as the employee disposes of the shares.

The effect of a security being exempted from the cost-averaging rule in subsection 47(1) is that the ACB of the security, and thus the capital gain or loss on its disposition, is determined without regard to the ACB of any other securities owned by the taxpayer. In other words, each security to which subsection 47(3) applies has its own unique ACB.

It should be noted that, under amended subsection 7(1.3) and new subsection 7(1.31) of the Act, it is possible to determine when each security which is exempted from the cost averaging rule by subsection 47(3) is disposed of by the taxpayer. As noted above, subsection 7(1.31) deals with situations in which there is an acquisition of an employee option security and a disposition of an identical security within 30 days. Amended subsection 7(1.3) deals with securities for which a deferral is provided under subsection 7(1.1) or (8) or 147(10.1) of the Act (referred to in these notes as "deferral securities"). In general terms, subsection 7(1.3) deems a taxpayer to dispose of deferral securities only after having disposed of non-deferral securities, and then to dispose of deferral securities in the order in which they were acquired. Since it is possible to determine exactly when a particular security to which subsection 47(3) applies is disposed of, the fact that the security has its own unique ACB is not problematic.

It should also be noted that, where an employee acquires a security after February 27, 2000 under circumstances to which subsection 7(1.1) or (8) apply, the deferred employment benefit is added, pursuant to amended paragraph 53(1)(*j*) of the Act, to the ACB of the security at the time it is acquired even though the benefit is not subject to taxation until the security is disposed of.

The following examples illustrate the effect of subsection 47(3), in conjunction with the rules in subsections 7(1.3) and 7(1.31) for determining the order of disposition of identical securities and the amended ACB rule for employee option securities in paragraph 53(1)(*j*) of the Act.

***Example 1***

*On March 1, 1998, Simon acquires 50 shares of his corporate employer on the open market for $5 each. The ACB of each share is $5. On March 1, 1999, Simon acquires another 50 shares on the open market for $15 each. By virtue of subsection 47(1), the ACB of each of the 100 shares is $10 (= ((50 x $5) + (50 x $15)) divided by 100).*

*On March 1, 2001, Simon exercises two different employee stock options and acquires two additional company shares. The fair market value (FMV) at that time is $100 per share. One of the options was granted on July 1, 1999 and has an exercise price of $25. The other option was granted on July 1, 2000 and has an exercise price of $30.*

*Simon elects under subsection 7(8) to defer recognition of the employment benefit of $75 (= $100 - $25) associated with the option granted in 1999 as well as the employment benefit of $70 (= $100 - $30) associated with the option granted in 2000. Because of the election, subsection 47(3) excludes the shares from the cost-averaging rule in subsection 47(1). Thus, the ACB of the share acquired under the option granted in 1999 is $100 (= $25 cost amount + $75 deferred employment benefit added pursuant to amended paragraph 53(1)(j)). The ACB for the other stock option share is also $100 (= $30 cost amount + $70 deferred employment benefit added pursuant to paragraph 53(1)(j)).*

*Because of the application of subsection 47(3), the acquisition of the stock option shares does not affect the ACB of the previously-acquired 100 shares, which remains at $10 a share.*

*On March 1, 2002, Simon acquires an additional stock option share. The option was also granted on July 1, 2000 and has an exercise price of $30. The FMV of the share is $150. He elects, under subsection 7(8), to defer recognition of the employment benefit of $120 (= $150 - $30). Because of the election, the share is excluded from the cost-averaging rule. Thus, the ACB of the share is $150 (= $30 cost amount + $120 deferred employment benefit added pursuant to paragraph 53(1)(j)).*

*Because of the application of subsection 47(3), the ACB of the 100 market shares remains unchanged at $10 a share. Similarly, the ACB of each of the stock option shares acquired on March 1, 2001 remains unchanged at $100.*

*On December 1, 2003, Simon sells 60 shares for $160 a share. By virtue of subsection 7(1.3), Simon is deemed to have sold the 50 shares that he acquired on the open market on March 1, 1998, and 10 of the 50 shares that he acquired on the open market on March 1, 1999. The capital gain on each share is $150 (= $160 proceeds of disposition - $10 ACB), and the total capital gain is $9,000 (=$150 x 60).*

*In 2004, Simon sells another 40 shares for $180 a share. By virtue of subsection 7(1.3), he is deemed to have sold the remaining shares that he acquired on the open market. The capital gain on each share is $170 (= $180 proceeds of* *disposition - $10 ACB), and the total capital gain is $6,800 (= $170 x 40).*

*In 2005, Simon sells another share for $220. By virtue of subsection 7(1.3), he is deemed to have sold the stock option share that he acquired on March 1, 2001 under the option that was granted on July 1, 1999. In his tax return for 2005, he reports the employment benefit of $75 and the capital gain of $120 (= $220 - $100).*

*In 2006, he sells another share for $190. By virtue of subsection 7(1.3), he is deemed to have sold the stock option share that he acquired on March 1, 2001 under the option that was granted on July 1, 2000. In his tax return for 2006, he reports the employment benefit of $70 and the capital gain of $90 (= $190 - $100).*

*In 2007, Simon sells the one remaining share for $245. By virtue of subsection 7(1.3), he is deemed to have sold the stock option share that he acquired on March 1, 2002. In his tax return for that year, he reports the employment benefit of $120 and the capital gain of $95 (= $245 - $150).*

*If we were to assume that, in 2007, Simon acquired an additional share on the open market and later that year disposed of only one of the two shares in his possession, subsection 7(1.3) would deem the newly-acquired market share, rather than the one remaining stock option share, to be the share that is the subject of the disposition.*

***Example 2***

*Margaret owns 100 shares of her corporate employer. The shares have an ACB of $6 each. In July 2001, Margaret acquires another share under an employee stock option. The exercise price is $50 and the FMV is $150. As a result of the acquisition, she is deemed to have received a benefit from employment equal to $100, and is entitled to deduct 1/2 of the employment benefit under paragraph 110(1)(d). The share is publicly listed.*

*Margaret immediately donates an identical share to a qualifying charity. Under subsection 7(1.31), she identifies the* *newly-acquired share as the share being donated and, thus, is entitled to deduct another 1/4 of the employment benefit under paragraph 110(1)(d.01).*

*Because of the specific identification under subsection 7(1.31), the donated share is deemed not to be identical to the other shares for purposes of the cost-averaging rule in subsection 47(1). As a result, the ACB of the donated share is $150 (= $50 exercise price + $100 employment benefit). Under subsection 69(1), Margaret is deemed to have received proceeds of disposition for the donated share equal to its FMV at the time of donation, which is also $150. Therefore, there is no capital gain or loss determined in connection with the donated share. Furthermore, because of the application of subsection 47(3), the $6 ACB of the previously-acquired shares is unaffected by the acquisition of the donated share.*

## Clause 33

### Gain When Small Business Corporation Becomes Public

ITA
48.1(1)(*a*)(ii)

Section 48.1 of the Act allows the owner of qualified small business corporation shares to access the capital gains exemption under subsection 110.6(2.1) of the Act in respect of those shares when the corporation lists its shares on a prescribed stock exchange in Canada or outside of Canada. The listing of the shares on a prescribed stock exchange results in the shares losing their status as qualified small business corporation shares. Such a shareholder may elect to be treated as having disposed of the shares immediately before the change in the corporation's status, in order to realize all or any part of any latent capital gain on the shares. The shareholder is then treated as having reacquired the shares at a cost equal to their deemed proceeds of disposition.

Subsection 48.1(1) is amended as a consequence of amendments to the definition of "Canadian-controlled private corporation" (CCPC) in subsection 125(7) of the Act. In order to be a small business corporation as defined in subsection 248(1) of the Act, a corporation must, among other things, be a CCPC. The amended definition of CCPC will, however, deny CCPC status to a corporation controlled by a Canadian resident corporation with shares listed on a prescribed stock exchange outside of Canada. Such a corporation will, therefore, no longer qualify as a small business corporation, and, in the absence of a rule allowing the shareholder to trigger a capital gain that had accrued before the change of the corporation's status, its shares would not be eligible for the capital gains exemption. Subparagraph 48.1(1)(*a*)(ii) of the Act is amended to ensure that the election under section 48.1 is available to realize a capital gain in such a case.

Not only will shareholders of subsidiaries controlled by corporations that have newly listed their shares on a prescribed foreign exchange qualify to make the election, but also those subsidiaries controlled by a corporation the shares of which were already listed on a prescribed foreign exchange on January 1, 2000, when the revised CCPC definition takes effect. If a subsidiary's parent corporation's shares were listed on that date, and the subsidiary was a small business corporation on December 31, 1999, an election under section 48.1 by an individual shareholder of the subsidiary will be treated as having been made in a timely manner provided it is made on or before the individual's filing-due date for the taxation year in which the Bill implementing this amendment receives Royal Assent.

Amended subparagraph 48.1(1)(*a*)(ii) applies to corporations that cease to be small business corporations after 1999.

## Clause 34

### Options – Extension or Renewal

ITA
49(5)(*b*)

Subsection 49(5) of the Act sets out rules dealing with extensions or renewals of an option.

Subsection 49(5) is amended to change a cross-reference in the subsection to the definition "disposition" in section 54 to a corresponding cross-reference to the new definition "disposition" in subsection 248(1).

This amendment applies to options granted after December 23, 1998.

## Clause 35

### Cost of Certain Property

ITA
52(1) and (1.1)

Subject to a number of exceptions, subsection 52(1) of the Act provides that, where an amount in respect of the value of a property has been included in computing a taxpayer's income, that amount is added in determining the cost to the taxpayer of the property for the purposes of determining capital gains and losses in respect of the property. Subsection 52(1.1) provides a similar rule in respect of taxable Canadian property of non-residents, except that it refers to a taxpayer's taxable income earned in Canada (as well as any amount subject to Part XIII withholding tax) instead of a taxpayer's income. These subsections do not apply to rights to enforce payments from a trust that are described in subsection 52(6).

Subsection 52(1) is amended and subsection 52(1.1) is repealed so that subsection 52(1) applies to all taxpayers, whether resident in Canada or not. Amended subsection 52(1) generally applies where a taxpayer acquired property and an amount in respect of its value was included in computing the taxpayer's income for a taxation year throughout which the taxpayer was resident in Canada (or in computing a non-resident taxpayer's taxable income earned in Canada under section 115, taxable income under section 114 or an amount from which tax is withheld under Part XIII).

The exceptions in existing subsection 52(1) also generally apply for the purposes of amended subsection 52(1). However, the exception relating to subsection 52(6) is eliminated because of the repeal of that subsection (as described in the commentary below). Instead, amended subsection 52(1) excepts property that is a beneficiary's right to enforce payments by a trust or that is acquired in satisfaction of a beneficiary's "capital interest" in the trust (as defined in amended subsection 108(1)).

These amendments apply after 1999, except with respect to property that is acquired before 2000 and disposed of before March 2000.

## Cost of Right to Receive from Trust

ITA
52(6)

Subsection 52(6) of the Act provides that, where a right to enforce payment by a trust of an amount out of the trust's capital gains or income (determined without reference to the provisions of the Act) for the trust's taxation year is acquired by a trust beneficiary in the year, the beneficiary's cost of the right is the amount that became so payable. This ensures that there is generally no capital gain realized where a payment is made in satisfaction of such a right.

Subsection 52(6) is being repealed. Instead, rights to which subsection 52(6) apply are now generally treated as part of a taxpayer's "income interest" or "capital interest" in a trust (as those expressions are defined in subsection 108(1)). Because of new paragraphs (*h*) and (*i*) of the definition "disposition" in subsection 248(1), where the right is part of a taxpayer's capital interest in a trust, the satisfaction of the right by way of a distribution by the trust will generally not constitute a disposition of that interest. In addition, under existing paragraph 53(2)(*h*), a distribution in satisfaction of such a right generally will not result in a reduction of the adjusted cost base of that interest. In the event that such a right is capitalized by way of the issue of new trust units, new subsection 248(25.3) expressly provides for the cost of the new units. Where a taxpayer's right to enforce payment of an amount is disposed of to a third party prior to the right being satisfied by the trust, new subsection 248(25.4) provides, where the requirements of that subsection are met, an increase in the cost of the taxpayer's capital interest in the trust.

The repeal of subsection 52(6) and the related amendments (described above) are designed to clarify the tax consequences of distributions from trusts to their beneficiaries after 1999. For the large part, the end results achieved under these rules accord with existing income tax practice.

The repeal of subsection 52(6) applies after 1999, except with respect to property that is acquired before 2000 and disposed of before March 2000.

## Clause 36

### Adjustments to Cost Base

ITA
53

Section 53 of the Act sets out rules for determining the adjusted cost base of capital property for the purposes of calculating any capital gain or loss on its disposition. Certain adjustments to cost are made under this section. Subsection 53(1) provides for additions to cost and subsection 53(2) for deductions from cost.

ITA
53(1)(*e*) and (2)(*c*)

Paragraph 53(1)(*e*) provides additions to a taxpayer's cost of a partnership interest for the purpose of determining its adjusted cost base. Clause (i)(A) thereof provides an addition to the cost base for each fiscal period of the partnership equal to the amount that would be the taxpayer's share of the income of the partnership for that fiscal period if any amounts included in income in respect of eligible capital property, taxable capital gains and taxable net gains on listed personal property for that fiscal period were computed without reference to the fractions referred to in those provisions.

Paragraph 53(2)(*c*) provides deductions from the taxpayer's cost of a partnership interest for the purpose of determining its adjusted cost base. Clause (i)(A) thereof provides for a deduction from the cost base for each fiscal period of the partnership equal to the amount that would be the taxpayer's share of any loss of the partnership for that fiscal period if any amounts deducted in respect of eligible capital property and allowable capital losses of the partnership were computed without the references to the fractions referred to in those provisions.

Clauses 53(1)(*e*)(i)(A) and 53(2)(*c*)(i)(A) are amended to add the references to the fraction in the formula in paragraph 14(1)(*b*) of the Act (as amended) and the variable C in that formula. These changes are consequential to the changes to the inclusion rates for the inclusion in income from business under subsection 14(1). Clause 53(1)(*e*)(i)(A) is also amended to correct an oversight in 1997 about the fraction in paragraph 38(*a*.1) concerning the taxable portion of a capital gain arising from certain donations.

These amendments apply in respect of fiscal periods that end after February 27, 2000.

ITA
53(1)(*j*)

Paragraph 53(1)(*j*) of the Act provides for an addition to the adjusted cost base (ACB) of a security (i.e., a share of a corporation or a unit of a mutual fund trust) acquired by a taxpayer under an employee option agreement. The amount that is added to the ACB is the amount of the employment benefit that the taxpayer (or a non-arm's length person) is deemed by subsection 7(1) to have received in connection with the acquisition of the security. The amount is generally equal to the excess of the fair market value of the security at the time it is acquired over the amount paid to acquire the security under the option. The amount is added to the ACB in the year in which the benefit is deemed to have been received, which is generally the year in which the taxpayer acquires the security. However, in the case of an option granted by a Canadian-controlled private corporation (CCPC) to an arm's length person, subsection 7(1.1) applies to defer recognition of the benefit to the year in which the taxpayer disposes of the security.

Paragraph 53(1)(*j*) is amended to provide that, for all employee option securities acquired after February 27, 2000, the employment benefit is included in the ACB of the security from the time of acquisition, even if recognition of the employment benefit is deferred, for tax purposes, until the taxpayer disposes of the security. This will be relevant primarily where securities for which a deferral is provided under subsection 7(1.1), or under new subsection 7(8) (which applies to publicly-listed shares and units of a fund trust), are exchanged for new securities in accordance with subsection 7(1.5), but in circumstances in which there is no rollover available in respect of the disposition of the old securities for capital gains purposes. The immediate inclusion in the ACB of the old securities ensures that the determination of the capital gain or loss on the disposition of those securities is not distorted by the exclusion of the deferred employment benefit associated with the acquisition of those securities.

ITA
53(1)(*r*)A(ii)

Paragraph 53(1)(*r*) of the Act increases an individual's adjusted cost base of each interest in, or share of the capital stock of, a flow-through entity described in any of paragraphs (*a*) to (*f*) of the definition "flow-through entity" by a pro-rata portion of the amount of the individual's unused exempt capital gains balance in respect of the entity where the individual disposes of all interests in and shares of the capital stock of the entity.

For the purpose of determining the unused portion of the individual's exempt capital gains balance in respect of the entity, the balance for the year is reduced by the total of all reductions in the year in capital gains because of the balance and 4/3 of the total of all reductions in the year of taxable capital gains or business income because of the balance.

Subparagraph (ii) of the description of A in paragraph 53(1)(*r*) is amended to replace the expression "4/3 of" with the word "twice".

The amendment is consequential to the reduction of the inclusion rates for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxpayer's taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" in that subparagraph is to be read as reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies in respect of the entity for its taxation year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

ITA
53(2)(*a*)

Subparagraph 53(2)(*a*) of the Act provides for a reduction in the adjusted cost base of a share of an individual provided for under various provisions of the Act. The amendment to that subparagraph adds a reference to new paragraph 44.1(2)(*b*) of the Act which requires a reduction in the adjusted cost base of a replacement share of an individual as defined in new section 44.1.

This amendment applies to dispositions that occur after February 27, 2000.

ITA
53(2)(*c*)(i)(A)

See the commentary on the amendment to clause 53(1)(*e*)(i)(A).

ITA
53(2)(*c*)(ii)(B)

Paragraph 53(2)(*c*) of the Act provides for certain amounts that must be deducted in computing the adjusted cost base to a taxpayer of a partnership interest. Under subparagraph 53(2)(*c*)(ii), the deducted amounts at any time include the taxpayer's share of specified resource expenses (including foreign exploration and development expenses) for each fiscal period of the partnership that ends before that time. This treatment is provided because a taxpayer's share of each specified resource expense enters directly into the calculation of a taxpayer's resource deductions under sections 66 to 66.4. Under subsection 96(1), the specified resource expenses are ignored in computing partnership income.

Clause 53(2)(*c*)(ii)(B) is amended so that the specified resource expenses include foreign resource expenses, as defined in the definition "foreign resource expense" in new subsection 66.21(1). (The new expression "foreign resource pool expenses", as defined in subsection 248(1), refers to both foreign resource expenses and foreign exploration and development expenses.)

This amendment applies to taxation years that begin after 2000.

ITA
53(2)(*h*)

Under paragraph 53(2)(*h*) of the Act, certain amounts are deducted in computing the adjusted cost base (ACB) to a beneficiary of the beneficiary's capital interest in a trust (other than an interest in a personal trust acquired for no consideration or an interest in a trust described in any of paragraphs (*a*) to (*d*) of the definition "trust" in subsection 108(1)) of the Act. Trusts described in these paragraphs are generally those deemed to exist for income tax purposes and those that relate to employee compensation and retirement savings. Among the deducted amounts (as described in subparagraph 53(2)(*h*)(i.1)) are certain amounts payable to a trust beneficiary in respect of the beneficiary's capital interest in a trust, otherwise than as proceeds of disposition.

Paragraph 53(2)(*h*) is amended to ensure that it does not apply to interests in trusts described in paragraphs (*e*) and (*e*.1) of the definition "trust" in subsection 108(1). Trusts referred to in these two paragraphs are cemetery care trusts, trusts governed by eligible funeral arrangements and trusts each of the beneficiaries of which is an employee compensation trust, retirement savings trust or related segregated fund trust. This amendment corrects a legislative oversight.

Paragraph 53(2)(*h*) is also amended so that it does not apply to an interest in a personal trust that has never been acquired for consideration. New paragraph 108(6)(*c*) and new subsection 108(7) of the Act are relevant for the purpose of determining when an interest in a trust is considered to have been acquired for consideration.

These amendments apply to amounts that become payable after 1999.

Further, subclause 53(2)(*h*)(i.1)(B)(I) of the Act is amended to delete the expression "1/3 of". This amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2, and generally applies to taxation years that end after February 27, 2000.

Where the trust's taxation year that ends in the taxation year of the taxpayer includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the expression "that is equal to the" is to be read as reference to the amount that is equal to the fraction obtained when 1 is subtracted from the reciprocal of the fraction in amended paragraph 38(*a*) of the Act that applies to the trust for its taxation year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

ITA
53(2)(*i*) and (*j*)

Paragraphs 53(2)(*i*) and (*j*) of the Act set out certain reductions required to be made in determining the adjusted cost base (ACB) of a capital interest in a non-resident trust (including a unit of a non-resident unit trust) acquired by a purchaser. The ACB reduction in respect of a capital interest in such a trust occurs, in general terms, where the purchaser acquired the interest from a non-resident person and assets of the trust consist primarily of any combination of taxable Canadian properties, Canadian resource properties, timber resource properties and income interests in trusts resident in Canada. The ACB reduction reduces the overall tax advantages associated with the sale of such capital interests by reducing the ACB to the purchaser of the capital interest. The ACB reduction takes into account the deferral of the recognition of gains on such properties that used to result when a capital interest in a trust holding such properties (rather than the underlying properties) was sold by a non-resident person.

Paragraphs 53(2)(*i*) and (*j*) are amended so that such ACB reductions are no longer required in connection with purchases of a capital interest in a trust, where the interest is taxable Canadian property to the non-resident vendor. This amendment, which is relevant to purchases after April 26, 1995, is consequential to the extension of taxable Canadian property (under former subsection 115(1) and the new definition "taxable Canadian property" in subsection 248(1)) to include capital interests in a non-resident trust in cases where the trust's assets consist primarily of taxable Canadian properties and other properties described above.

ITA
53(3)

Subsection 53(3) of the Act provides that, for the purposes of certain deductions required to be made in determining the adjusted cost base of interests in non-resident trusts, property of a trust is taxable Canadian property (TCP) at a particular time if the property would be TCP if the trust had disposed of the property at that time.

Subsection 53(3) is repealed with effect after October 1, 1996. This amendment is consequential to changes in the definition of TCP (described in the commentary on subsection 248(1) of the Act) and does not represent any change in tax policy.

ITA
53(4)

Subsection 53(4) of the Act provides rules that affect the computation of the adjusted cost base (ACB) to a taxpayer of any "specified property". As defined in section 54, "specified property" is capital property that is a share, a capital interest in a trust, a partnership interest or an option to acquire any such property. The rules in subsection 53(4) apply where the proceeds of disposition of a specified property are determined under any one of a number of provisions in the Act set out in the subsection. Where this is the case and the ACB of the specified property was reduced under paragraph 53(2)(*g*.1) as a consequence of a forgiveness of debt, the ACB continues to be reduced under that paragraph as a consequence of the operation of subsection 53(4). The only significance of this reduction is with respect to the potential future application of section 80.03 which, in certain cases, recaptures reductions previously made under paragraph 53(2)(*g*.1) in computing the ACB of specified property on a future disposition of such property.

Subsection 53(4) is amended to add a reference in the subsection to paragraph 107.4(3)(*a*). Subsection 107.4(3) provides for a rollover on certain transfers of property that do not involve any change in the beneficial ownership of the property. As a result, the ACB of a property transferred to a trust that was subject to a reduction because of the forgiveness of debt rules continues to be reduced on the same basis if the property is transferred in circumstances where proceeds of disposition are determined under paragraph 107.4(3)(*a*).

This amendment applies to the 1998 and subsequent taxation years.

## Clause 37

### Definitions – Capital Gains and Losses

ITA
54

"disposition"

The expression "disposition" is defined, for the purposes of the capital gains rules, in section 54 of the Act.

The definition is repealed as a consequence of the introduction of the new definition "disposition" in subsection 248(1).

The repeal of this definition applies to transactions and events that occur after December 23, 1998.

"principal residence"

Section 54 of the Act defines a number of expressions for the purpose of subdivision c of Division B of Part I, which deals with taxable capital gains and allowable capital losses. The definition "principal residence" in section 54 provides criteria for the classification of a dwelling as the principal residence of a taxpayer for the purposes of the exemption of such property from capital gains taxation.

Under existing rules, a family unit may treat only one housing unit as its principal residence for a taxation year. For years before 1982, it was possible in the case of a married couple for each spouse to designate a principle residence for the purpose of capital gains exemption. However, as a result of an intervening amendment applicable to dispositions occurring after 1990, a strict interpretation of the definition would deny a taxpayer the benefit of the pre-1982 rules. This result is clearly unintended and the amendment reconfirms the benefit of the pre-1982 rules.

This amendment applies to dispositions that occur after 1990.

This amendment also reflects changes effected by the *Modernization of Benefits and Obligations Act*.

## Clause 38

### Avoidance

ITA
55

Section 55 of the Act deals with certain tax avoidance transactions.

Subsection 55(2) of the Act is an anti-avoidance provision directed against certain arrangements designed to use the inter-corporate dividend exemption to unduly reduce a capital gain on the sale of shares. It treats the dividend in these situations either as proceeds from the sale of the shares or as a capital gain, and not as a dividend received by the corporation.

Subsection 55(3) of the Act sets out circumstances in which subsection 55(2) of the Act does not apply to dividends.

Paragraph 55(3)(*b*) provides an exemption from the application of subsection 55(2) for dividends received in the course of a reorganization (commonly referred to as divisive or butterfly reorganizations) in which a distribution is made by a distributing corporation to one or more transferee corporations. Because of the meaning of "distribution" in subsection 55(1), each transferee corporation must receive its pro rata share of each type of property owned by the distributing corporation immediately before the distribution.

As a result of the new definitions "specified corporation" and "specified wholly-owned corporation" in subsection 55(1) and new subsection 55(3.02) of the Act, the requirement that each transferee corporation must receive its pro rata share of each type of property owned by the distributing corporation on a butterfly reorganization will no longer apply in the case of certain public corporation butterflies. In particular, the type of property requirement will no longer apply for butterfly reorganizations of specified corporations that occur after 1998.

**Definitions**

ITA
55(1)

"specified corporation"

In order for a distributing corporation to qualify as a "specified corporation":

1) it must be a public corporation or specified wholly-owned corporation of a public corporation (specified wholly-owned corporation is a new expression and it is defined in subsection 55(1) of the Act);

2) shares of the distributing corporation must be exchanged for shares of another corporation (an "acquiror") in an exchange to which the definition "permitted exchange" in subsection 55(1) of the Act would apply if the definition "permitted exchange" were read without reference to paragraph (*a*) and subparagraph (*b*)(ii) thereof;

3) the distributing corporation must not make a distribution to a corporation other than an acquiror after 1998 and before the day that is three years after the day on which the distributing corporation shares were exchanged in a transaction referred to in 2) above; and

4) no acquiror in relation to the distributing corporation may make a distribution after 1998 and before the day that is three years after the day on which the distributing corporation shares were exchanged in a transaction referred to in 2) above.

Reading the definition of "permitted exchange" without reference to paragraph (*a*) and subparagraph (*b*)(ii) ensures that the exchange of shares of the capital stock of the distributing corporation for shares of the acquiror is effected in the course of what is commonly referred to a "spin-off" reorganization. In a spin-off reorganisation, property owned by the distributing corporation is transferred to a new corporation having the same shareholders as the distributing corporation.

The new definition of specified corporation also sets out the consequences of an amalgamation of corporations or a winding-up of a subsidiary corporation to which subsection 88(1) of the Act applies. Paragraph (*e*) of the definition provides that a corporation formed on an amalgamation is treated as a continuation of each of its predecessors. Paragraph (*f*) of the definition provides that, in the case of a winding-up of a subsidiary corporation into its parent to which subsection 88(1) of the Act applies, the parent corporation is treated as a continuation of the subsidiary.

"specified wholly-owned corporation"

The new definition of specified wholly-owned corporation of a public corporation is relevant for the purpose of the new definition "specified corporation". A specified wholly-owned corporation of a public corporation means a corporation all of the outstanding shares of the capital stock of which (other than directors' qualifying shares and shares of a specified class) are held by a public corporation, a specified wholly-owned corporation or any combination of the two. The meaning of a specified class is set out in subsection 55(1) of the Act.

The new definitions of specified corporation and specified wholly-owned corporation apply to transfers of property that occur after 1998.

## Distribution by a Specified Corporation

ITA
55(3.02)

New subsection 55(3.02) of the Act provides that where the distribution is by a "specified corporation" to an acquiror described in the definition "specified corporation" in subsection 55(1), the definition "distribution" in subsection 55(1) is to be read as if the reference in that definition to "each type of property" were read as "property" and to "property of that type" were read as "property". These changes ensure that divisive reorganizations, commonly known as "butterfly reorganizations", of specified corporations will be required to effect a proportionate distribution of the overall property of the corporation undergoing the divisive reorganization rather than of each type of property. subsection 55(3.02) applies to transfers of property that occur after 1998.

**Applicable Rules**

ITA
55(5)

Subsection 55(5) of the Act sets out rules applicable to section 55.

ITA
55(5)(*b*)

Paragraph 55(5)(*b*) of the Act provides rules for the calculation of income for the purposes of section 55. Subparagraph 55(5)(*b*)(iii) adds to income otherwise determined the "untaxed portion" of gains in respect of eligible capital property. Because, under existing paragraph 14(1)(*b*), a corporation's gain in respect of eligible capital property was previously aggregated with a recapture of the paragraph 20(1)(*b*) deductions that were previously claimed, subparagraph 55(5)(*b*)(iii) describes the untaxed portion of gains in respect of eligible capital property by reference to the corporation's cumulative eligible capital, eligible capital expenditures and variable E in the definition "cumulative eligible capital".

Amended paragraph 14(1)(*b*) of the Act identifies the taxable (2/3 for taxation years that end after February 27, 2000 and before October 18, 2000 and 1/2 for taxation years that end after October 17, 2000) portion of gains in respect of eligible capital property. Consequently it is possible to simplify the description of the untaxed (1/3) portion of gains in respect of eligible capital property for taxation years that end after February 27, 2000 and before October 18, 2000 and (1/2) portion for taxation years that end after October 17, 2000. Subparagraph 55(5)(*b*)(iii) is, therefore, amended to describe deemed income as calculated under that provision as it applied to taxation years that ended before February 28, 2000.

New subparagraph 55(5)(*b*)(iv) generally requires the inclusion in the calculation of income under paragraph 55(5)(*b*) of 1/2 of all amounts required by amended paragraph 14(1)(*b*) to be included in the corporation's income for taxation years that end after February 27, 2000 and before October 18, 2000.

New subparagraph 55(5)(*b*)(v) requires the inclusion of the amount required by paragraph 14(1)(*b*) to be included for taxation years that end after October 17, 2000.

Both these amounts are reduced to take into account the appropriate portion of bad debts in respect of dispositions of eligible capital property. The calculation of the reduction for bad debts is complicated by the interaction of different inclusion rates for capital gains that may be relevant during the period. New subparagraphs 55(5)(*b*)(iv) and (v) recognize both the deduction under subsection 20(4.2) of the Act and the deemed allowable capital loss under subsection 20(4.3) of the Act as amounts that reduce safe income. For further detail, see the commentary to subsections 20(4.2) and (4.3).

These amendments apply in respect of taxation years that end after February 27, 2000.

Subparagraph 55(5)(*e*)(iv) of the Act provides that in determining, for the purposes of section 55, whether persons are related to each other or whether control of a corporation has been acquired, persons will be treated as not being related to each other if they are related to each other only because of a right referred to in paragraph 251(5)(*b*) of the Act. Amended subparagraph 55(5)(*e*)(iv) provides that, for the purposes of determining, for the purposes of section 55, whether persons are related to each other or whether control of a corporation has been acquired, the Act is to be read without reference to paragraph 251(5)(*b*) and section 251(3) of the Act. This will have the effect of ensuring that corporations will not be considered to be related to each other by reason only that they are each related to a third corporation.

New subparagraph 55(5)(*e*)(iv) of the Act applies to dividends received after November 1999 other than dividends received as part of a series of transactions or events that were required, before December 1999, to be carried out pursuant to an agreement in writing made before December 1999.

## Clause 39

### Scholarships, Bursaries, etc.

ITA
56(1)(*n*) and (3)

Paragraph 56(1)(*n*) of the Act provides for the inclusion in a taxpayer's income for a year of certain scholarships, fellowships, bursaries and prizes for achievement, to the extent that the total of such amounts received in the year exceeds $500. The addition of subparagraph 56(1)(*n*)(ii) and subsection 56(3) provide for an additional $2,500 exemption for scholarships, fellowships and bursaries received by a taxpayer in connection with the taxpayer's enrolment in a program in respect of which the taxpayer may claim the education tax credit.

These amendments apply to the 2000 and subsequent taxation years.

## Clause 40

### Consideration for Foreign Resource Property

ITA
59(1) and (1.1)

Subsection 59(1) of the Act applies where a taxpayer has disposed of a foreign resource property. In computing the taxpayer's income for a taxation year, the proceeds of disposition that become receivable in the year are included in computing the taxpayer's income (net of outlays and expenses incurred for the purpose of making the disposition).

Subsection 59(1) is amended so that, to the extent that the taxpayer so designates, there is no income inclusion under subsection 59(1) in connection with the disposition of a foreign resource property of the taxpayer in respect of a country. Instead, the amount so designated reduces the taxpayer's "cumulative foreign resource expense" pursuant to paragraph (*a*) of the description of F in the definition "cumulative foreign resource expense" in new subsection 66.21(1). This amendment applies to taxation years that begin after 2000.

New subsection 59(1.1) provides a look-through rule so that members of a partnership can avail themselves of a designation under subsection 59(1). Subsection 59(1.1) is similar to the existing rules for partnership members in subsections 66.2(6) and 66.4(6). A related change to paragraph 96(1)(*d*) provides that a member's share of partnership income is computed without reference to subsection 59(1). New subsection 59(1.1) applies to fiscal periods of partnerships that begin after 2000.

ITA
59(3.2)(*c*.1)

Subsection 59(3.2) of the Act provides for the inclusion in a taxpayer's income of specified amounts.

For this purpose, new paragraph 59(3.2)(*c*.1) specifies amounts determined under new subsection 66.21(3), relating to "negative" FRE balances. For further detail, see the commentary on new subsection 66.21(3).

This amendment applies to taxation years that begin after 2000.

ITA
59(5)

"disposition"

Subsection 59(5) of the Act defines the expressions "disposition" and "proceeds of disposition" for the purposes of section 59. These expressions are defined in the same way as they are defined in section 54.

Subsection 59(5) is amended to eliminate the references to the expression "disposition", as this expression is now defined in subsection 248(1).

This amendment applies to transactions and events that occur after December 23, 1998.

## Clause 41

## CPP/QPP Contributions on Self-Employed Earnings

ITA
60(*e*)

Section 60 of the Act provides for various deductions in computing income, including deductions in respect of certain payments to deferred income plans.

New paragraph 60(*e*) of the Act provides for the deduction of one-half of a taxpayer's contributions to the Canada or Quebec Pension Plan payable on the taxpayer's self-employed earnings, subject to one-half of the maximum of such contributions payable by the taxpayer under the plan. The appropriate percentage (generally the lowest marginal tax rate) of the other half of those contributions continues to be deductible under 118.7 (see the commentary on that section) in computing the taxpayer's tax payable.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 42

## Child Care Expenses

ITA
63

Section 63 of the Act provides rules concerning the deductibility of child care expenses in computing a taxpayer's income.

ITA
63(1)(*a*)

Subsection 63(1) of the Act allows, subject to certain conditions, the deduction of child care expenses paid in a calendar year in respect of an eligible child, whether the expenses are paid by the taxpayer or by a supporting person of the child for the year. This amendment replaces an incorrect reference in paragraph 63(1)(*a*) to "subparagraph (2)(*b*)(vi)" with a reference to "paragraph 63(2)(*b*)" in order to reflect an amendment made in 1998.

This amendment applies to the 1998 and subsequent taxation years.

ITA
63(1)(*e*)(ii)

Paragraph 63(1)(*e*) of the Act provides for the computation of a taxpayer's deduction in respect of child care expenses. The annual maximum amount of child care expenses that may be claimed for a year in respect of an eligible child depends on the child's age and whether or not a disability tax credit may be claimed in respect of the child. Subparagraph 63(1)(*e*)(ii) is amended to refer to the annual child care expense amount that is relevant to a particular eligible child. The new expression "annual child care expense amount" is defined in subsection 63(3) (see the commentary on that subsection).

This amendment applies to the 2000 and subsequent taxation years.

ITA
63(2)(*b*) and (2.3)(*c*)

Subsections 63(2) to (2.3) of the Act provide for the calculation of the child care expense deduction where the claimant is the higher-income supporting person, or where the claimant is a student. In such circumstances, the claim is subject to a specific maximum which is computed by reference to the number of weeks (or months for part-time education) during which the lower-income supporting person is separated, infirm, confined to a bed or wheelchair, in prison or in attendance at school. This specific maximum referred to in the formulas used in paragraphs 63(2)(*b*) and (2.3)(*c*) is amended to refer to the "periodic child care expense amount" in respect of a child. This new expression is defined in subsection 63(3) (see the commentary on that subsection).

These amendments apply to the 2000 and subsequent taxation years.

ITA
63(3)

Subsection 63(3) of the Act contains definitions for the purposes of the child care expense deduction.

"annual child care expense amount"

This new definition sets out the overall maximum amount that may be deducted for a year in respect of child care expenses for an eligible child. In the case of a child in respect of whom the disability tax credit may be claimed, the annual child care expense amount is increased to $10,000. For other eligible children, the deductible amount remains at $7,000 for children under 7 years of age at the end of the relevant year, and $4,000 for children aged 7 to 16 (or over if they are infirm).

This new definition applies to the 2000 and subsequent taxation years.

"child care expense"

Paragraph (*c*) of this definition provides for a specific maximum for expenses paid for an eligible child's attendance at a boarding school or camp. The maximum amount is computed by reference to the number of weeks of attendance at the school or camp. This paragraph is amended to refer to the "periodic child care expense amount" in respect of the child. This new expression is defined in subsection 63(3) (see the commentary on that subsection).

This new definition applies to the 2000 and subsequent taxation years.

"earned income"

Subsection 63(3) of the Act contains the definition "earned income" for the purpose of the child care expense deduction. In any year, an individual is allowed to deduct child care expenses of up to two thirds of the individual's earned income for that year. The amendment to the definition "earned income" is consequential to the replacement of the volunteers' deduction under paragraph 8(1)(*a*) with an equivalent exemption under subsection 81(4). The amendment ensures that an individual is entitled to the same child care expense deduction as would have been available if the volunteer's exempt income had been required to be included in income. For information on the exemption, see the commentary on new subsection 81(4).

This amendment applies to the 1998 and subsequent taxation years.

"periodic child care expense amount"

This new definition sets out the maximum that may be claimed on a monthly or weekly basis, which is relevant when a claim is made by the higher-income supporting person. In all cases, the periodic child care expense amount in respect of an eligible child is equal to 1/40 of the annual child care expense amount in respect of that child.

This new definition applies to the 2000 and subsequent taxation years.

## Clause 43

## Attendant Care Expenses

ITA
64

Section 64 of the Act permits the deduction, in computing the income of an individual who has a severe and prolonged mental or physical impairment, of expenses paid to an attendant (other than the individual's spouse or common-law partner) who is at least 18 years of age that are incurred to enable the individual to work. Such an individual is allowed to deduct the lesser of the actual amount of expenses for attendant care provided in Canada and 2/3 of the individual's income from specific sources. This includes income from business, gross employment income, net research grants and the taxable portion of scholarships, fellowships, bursaries and similar awards.

Section 64 of the Act is amended to expand the list of eligible sources of income to include certain earnings supplements and financial assistance included in income under paragraph 56(1)(*r*). It is also amended to extend the deduction (up to a maximum of $10,000) to an individual who incurs attendant care expenses to attend a designated educational institution (see the commentary on subsection 118.6(1)) or high school.

These amendments apply to the 2000 and subsequent taxation years.

### Clause 44

### Exploration and Development Expenses

ITA
66

Section 66 of the Act provides rules in respect of Canadian and foreign exploration and development expenses.

### Foreign Exploration and Development Expenses

ITA
66(4)

Subsection 66(4) of the Act sets out the deduction that may be claimed for foreign exploration and development expenses (FEDE) incurred by a taxpayer resident in Canada. A taxpayer's minimum deduction for a taxation year under this subsection is 10% of the taxpayer's undeducted FEDE balance at the end of the year. An additional portion of a taxpayer's undeducted FEDE balance may be deducted by a taxpayer for a taxation year, essentially to the extent of the taxpayer's foreign resource income in excess of that minimum amount.

ITA
66(4)(*a*)(i)

Subparagraph 66(4)(*a*)(i) is amended in two respects.

Firstly, it is amended so that a taxpayer's FEDE balance takes into account only expenses incurred while the taxpayer was resident in Canada. As a result, where a taxpayer becomes resident in Canada and, at the time of becoming resident, has foreign resource properties,

(a) expenses incurred before the taxpayer became resident in Canada are not taken into account in the FEDE balance (amended subparagraph 66(4)(*a*)(i)),

(b) there is a deemed acquisition of the taxpayer's foreign resource properties at fair market value pursuant to paragraph 128.1(1)(*c*) of the Act, and

(c) the deemed cost of the foreign resource properties may qualify as FEDE under paragraph (*c*) of the FEDE definition in subsection 66(15) of the Act. (However, under new paragraph (*k*) of the FEDE definition, which applies if the acquisition deemed by subsection 128.1(1)(*c*) occurs in a taxation year that begins after 2000, the deemed cost would not be included in the FEDE balance if it is a foreign resource expense (FRE) in respect of a country. The definition "foreign resource expense" is in new subsection 66.21(1).)

These amendments apply to the 1999 and subsequent taxation years.

Secondly, it is amended to cover the unusual situation where a taxpayer with FEDE ceases to reside in Canada and subsequently becomes resident in Canada. In these circumstances,

(a) the FEDE incurred during the taxpayer's prior periods of residence is not taken into account when the taxpayer is again resident in Canada (amended subparagraph 66(4)(*a*)(i)),

(b) there is a deemed acquisition at fair market value of the taxpayer's foreign resource properties on becoming resident in Canada (subsection 128.1(1)), and

(c) the deemed cost of the foreign resource properties may qualify as FEDE under paragraph (*c*) of the FEDE definition in subsection 66(15) of the Act. (However, under new paragraph (*k*) of the FEDE definition, which applies if the acquisition deemed by subsection 128.1(1)(*c*) occurs in a taxation year that begins after 2000, the deemed cost would not be included in the FEDE balance if it is a FRE in respect of a country.)

These amendments apply to the 2000 and subsequent taxation years.

ITA
66(4)(*b*)

Paragraph 66(4)(*b*) generally limits a taxpayer's deduction under subsection 66(4) for a taxation year to the greater of 10% of the taxpayer's undeducted foreign exploration and development expenses (FEDE) at the end of the year and an amount, determined under subparagraph 66(4)(*b*)(ii), representing the taxpayer's foreign resource income for the year. Only taxpayers who are resident in Canada throughout the whole of the taxation year may claim a deduction under subsection 66(4) in respect of FEDE.

Where a taxpayer ceases to be resident in Canada, special rules apply in respect of the FEDE deduction. These rules differ according to the date of the taxpayer's cessation of Canadian residence.

Where a taxpayer ceases, at any time that is

- in a taxation year that ends after 1994, and
- before February 28, 2000,

to be resident in Canada, new subparagraph 66(4)(*b*)(i.1)[1] of the Act generally allows the full amount of a taxpayer's undeducted FEDE balance to be deducted in the taxation year that occurs immediately before that time. Furthermore, new paragraph 115(1)(*e*.1) allows any remaining undeducted FEDE balance to be applied by the taxpayer, to offset taxable income earned in Canada, on a declining balance basis (10% per year).

Where a taxpayer ceases after February 27, 2000 to be resident in Canada, the rule in new subparagraph 66(4)(*b*)(i.1) is not applicable to the taxpayer. However, new paragraph 115(1)(*e*.1) would still permit the taxpayer to apply any undeducted FEDE balance, to offset taxable income earned in Canada, on a declining balance basis (10% per year).

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[1] as provided for in the coming-into-force provision of the amending Bill, to which these Notes pertain, that implements amendments to subsection 66(4) of the Act

As to the application of amended subsection 66(4) in the case where the taxpayer who has ceased to be resident in Canada is an individual, see the commentary to new subsection 66(4.3).

Subparagraph 66(4)(*b*)(ii) is amended so that deductions claimed under new subsection 66.21(4), which provides for the tax treatment of certain resource expenses that would be FEDE if they were incurred before 2001, do not result in any reduction of the foreign resource income determined under subparagraph 66(4)(*b*)(ii). This amendment is consequential to the introduction of section 66.21. This amendment applies to taxation years that begin after 2000.

Clause 66(4)(*b*)(ii)(C) is amended to clarify that deductions claimed by a taxpayer under subsection 66.7(2) (successor FEDE) will always result in a reduction of the taxpayer's foreign resource income determined under subparagraph 66(4)(*b*)(ii). Amended clause 66(4)(*b*)(ii)(C) also eliminates a reference to former section 64 that is no longer of any relevance. These amendments apply to taxation years that begin after 2000.

Note, in addition, that amendments are being made to the definition "foreign exploration and development expenses" in subsection 66(15). Under new paragraph (*k*) of that definition (which applies to taxation years that begin after 2000), an expense is not FEDE if the expense is a foreign resource expense (FRE) in respect of a country. The definition of FRE is in new subsection 66.21(1).

## Country-by-Country FEDE Allocation

ITA
66(4.1) and (4.2)

Under existing subsection 66(4) of the Act, FEDE in respect of one country is not distinct from FEDE in respect of any other country.

New subsection 66(4.1) provides that, to the extent that a FEDE deduction under subsection 66(4) can reasonably be considered to be in respect of "specified foreign exploration and development expenses" (as newly defined in subsection 66(15)) in respect of a country, for greater certainty that portion of the FEDE deduction is deemed to apply to a source in that country. As a consequence, that portion of the FEDE deduction can result in a reduction of the limit for the taxpayer's foreign tax credit under section 126 in respect of the country and, pursuant to subparagraph 66.21(4)(*a*)(ii)(C), can also result in a reduction of the limit for the taxpayer's deduction of foreign resource expenses under new section 66.21.

New subsection 66(4.2) elaborates on how an allocation to a country is made under subsection 66(4.1). The method of allocation must be reasonable in the circumstances and be consistently applied from year to year.

These amendments apply to taxation years that begin after 1999. However, in the event that a taxpayer elects to have the new foreign tax credit provisions in section 126 apply to taxation years that begin after an earlier date (but not earlier than December 31, 1994) designated by the taxpayer, these amendments apply on the same basis.

## FEDE Deductions Where Change of Individual's Residence

ITA
66(4.3)

New subsection 66(4.3) of the Act applies where an individual becomes, or ceases to be, resident in Canada in a taxation year.

Under section 128.1 of the Act, the immigration or emigration of an individual (other than a trust) has no impact on an individual's taxation year. Consequently, the individual would be resident in Canada for part of the taxation year and not resident in Canada for another part, with the result that, absent subsection 66(4.3), the individual would not be permitted to deduct an amount for the year under subsection 66(4). (This is because subsection 66(4) provides that, for a taxpayer to claim a deduction under that subsection for a taxation year, the taxpayer must be resident in Canada throughout the year.) Furthermore, the wording of section 114 that applies to the 1998 and subsequent taxation years would, absent subsection 66(4.3), preclude an individual who is resident in Canada for only part of a taxation year from obtaining a deduction in the year in respect of foreign exploration and development expenses (FEDE).

Consequently, subsection 66(4.3) provides that, for the purposes of subsection 66(4), a part-year resident's taxation year is treated as being the part of the taxation year throughout which the individual is resident in Canada and that, for these purposes, subsection 66(13.1) (which provides a rule relating to proration of deductions for short taxation years) does not apply to the individual for the year. As a result, an individual who is resident in Canada for only part of a taxation year can claim a full, non-prorated deduction under subsection 66(4). The deduction determined in this manner enters into the calculation of the individual's taxable income pursuant to section 114.

Given that section 128.1 operates to create new taxation years for trusts or corporations that become or cease to be resident in Canada, this measure has no relevance to trusts and there is no need to extend this measure to apply to corporations. Subsection 66(4.3) is parallel to new subsection 66.21(5), described in the commentary below.

This amendment applies to the 1998 and subsequent taxation years.

**Dealers**

ITA
66(5)

Subsection 66(5) of the Act provides that most of the special provisions with regard to the treatment of resource expenses do not apply in computing the income for a taxation year of a taxpayer (other than a principal-business corporation, as defined in subsection 66(15)) whose business includes trading or dealing in specified resource-related properties.

Subsection 66(5) of the Act is amended so that the subsection similarly limits the application of new section 66.21.

New subsection 66(5) applies to taxation years that begin after 2000.

## Change of Control

ITA
66(11.4)

Subsection 66(11.4) of the Act applies where there is an acquisition of control of a corporation that was not a principal-business corporation immediately before the 12-month period preceding that acquisition of control. Any Canadian or foreign resource property acquired by the corporation (or a partnership of which it was a majority interest partner) in that period is (except for the purposes of applying the successor rules in section 66.7, notably the acquisition of control rule in subsection 66.7(10)) considered to have been acquired at the time control is acquired, for the purpose of subsection 66(4) (FEDE), section 66.2 (Canadian development expenses) and section 66.4 (Canadian oil and gas property expenses). Consequently, the corporation is prevented from claiming deductions under subsection 66(4) and sections 66.2 and 66.4 in respect of the property so acquired until after the acquisition of control. An exception to this treatment generally applies where the property in question was owned before that 12-month period described above by the corporation, the partnership or a person that was affiliated with the corporation.

Subsection 66(11.4) is amended so that it also applies for the purpose of new section 66.21 (foreign resource expenses).

This amendment applies to taxation years that begin after 2000.

## Limitations of FEDE and Foreign Resource Expenses

ITA
66(12.4), (12.41) and (12.42)

Subsection 66(12.4) of the Act provides special rules that apply where an amount (referred to below as a "specified amount receivable") becomes receivable by a taxpayer as a consequence of consideration, given by the taxpayer, the original cost of which was FEDE. The subsection does not apply where the consideration given is foreign resource property, given that an income inclusion resulting from the disposition of a foreign resource property is provided under subsection 59(1). Where subsection 66(12.4) applies, a taxpayer's FEDE balance is reduced by the specified amount receivable. If the specified amount receivable exceeds the FEDE balance, the excess is included in income.

Subsection 66(12.4) is amended so that it also applies in connection with consideration the original cost of which is excluded from FEDE because of new paragraph (*k*) of the FEDE definition in subsection 66(15). That paragraph excludes amounts from FEDE that form part of a taxpayer's foreign resource expenses (as defined in the definition "foreign resource expense" in new section 66.21).

Subsection 66(12.4) is also amended so that a designated portion of a specified amount receivable is, to the extent that it is primarily in respect of specified FEDE in respect of a country (as newly defined in subsection 66(15)) or a foreign resource expense in respect of a country (as newly defined in subsection 66.21(1)), not taken into account under subsection 66(12.4). Instead, the amount so designated will be taken into account under new subsection 66(12.41). The intended effect of this amendment is to permit a taxpayer to elect out of the tax consequences under subsection 66(12.4).

Subsection 66(12.41) is introduced so that the designated portion of a specified amount receivable by a taxpayer in respect of a country results in a reduction of the "cumulative foreign resource expense" of the taxpayer in respect of that country.

Subsection 66(12.42) is introduced so that, where a partnership has a specified amount receivable, each partner of the partnership is considered for the purposes of subsections 66(12.4) and (12.41) to have had the partner's share of that amount become receivable. New subsection 66(12.42) is consistent with the fact that a partner's share of FEDE and foreign resource expenses qualifies as such.[2] In addition, subsection 66(12.42) is consistent with the existing treatment of amounts receivable by partnerships in connection with the calculation of "cumulative Canadian exploration expense"[3],

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[2] Existing paragraph (*d*) of the definition "foreign exploration and development expenses" in subsection 66(15) and paragraph (*e*) of the definition "foreign resource expenses" in new subsection 66.21(1).

[3] See reference to the description of G in that definition in subsection 66.1(7).

"cumulative Canadian development expense"[4] and "cumulative Canadian oil and gas property expense".[5]

Amended subsection 66(12.4) and new subsection 66(12.41) apply to taxation years that begin after 2000. New subsection 66(12.42) applies to fiscal periods that begin after 2000.

**Short Taxation Year**

ITA
66(13.1)

Subsection 66(13.1) of the Act limits the amount of FEDE, Canadian development expenses and Canadian oil and gas property expenses that a taxpayer may deduct in computing income where the amount is based on a percentage of the unclaimed balance. For a taxation year that is less than 51 weeks, the amount that may be deducted cannot exceed that portion of the amount otherwise determined that the number of days in the taxation year is of 365.

Subsection 66(13.1) is amended to similarly apply in determining the amount of foreign resources expenses deductible under new subsection 66.21(4) and successor foreign resource expenses deductible under new subsection 66.7(2.3).

This amendment applies to taxation years that begin after 2000.

**Definitions**

ITA
66(15)

Subsection 66(15) of the Act contains various definitions for the purposes of section 66.

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[4] See reference to the description of G in that definition in subsection 66.2(6).

[5] See reference to the description of G in that definition in subsection 66.4(6).

"Canadian resource property"

The definition "Canadian resource property" is set out in subsection 66(15).

Paragraph (*c*) of that definition covers "any oil or gas well in Canada or any real property in Canada the principal value of which depends on its petroleum or natural gas content (but not including any depreciable property used or to be used in connection with the extraction or removal of petroleum or natural gas therefrom)". This paragraph is amended to delete the words "used or to be used in connection with the extraction or removal of petroleum or natural gas therefrom" following the words "depreciable property". This amendment parallels new paragraph (*c*) of the amended definition "foreign resource property" in subsection 248(1), as described in the commentary below. This amendment applies to taxation years that begin after 2000.

Paragraph (*f*) of that definition covers "any real property in Canada the principal value of which depends on its mineral resource content (but not including any depreciable property used or to be used in connection with the extraction or removal of minerals therefrom)". This paragraph is amended to delete the words "used or to be used in connection with the extraction or removal of minerals therefrom " following the words "depreciable property". This amendment parallels new paragraph (*f*) of the amended definition "foreign resource property" in subsection 248(1), as described in the commentary below. This amendment applies to taxation years that begin after 2000.

"foreign exploration and development expenses"

The definition "foreign exploration and development expenses" (FEDE) is set out in subsection 66(15) of the Act. FEDE balances are deductible to the extent provided under subsection 66(4). Paragraph (*b*) of the definition includes in FEDE any prospecting, exploration or development expenses incurred by a taxpayer in searching for minerals outside Canada. A number of explicit exclusions from FEDE are provided under paragraphs (*f*) to (*i*) of the definition.

Paragraph (*b*) of the definition is amended so that prospecting, exploration and development expenses covered by that paragraph must be incurred for the purpose of determining the existence, location, extent or quality of a "mineral resource" (as defined in subsection 248(1)) outside Canada. This amendment makes paragraph (*b*) of the FEDE definition more consistent with paragraph (*f*) of the definition "Canadian exploration expense" in subsection 66.1(6). This amendment applies to expenses incurred after December 21, 2000, other than expenses incurred pursuant to an agreement in writing made before December 22, 2000.

Paragraph (*j*) of the definition is introduced to ensure that an expenditure that is the cost, or any part of the cost, to the taxpayer of depreciable property of a prescribed class is excluded from FEDE. This measure, which complements existing paragraph (*f*) of the definition, is provided for greater certainty and is consistent with similar language in the exclusions within the definitions "Canadian exploration expense" in subsection 66.1(6) and "Canadian development expense" in subsection 66.2(5). This amendment applies to property acquired after December 21, 2000.

New paragraph (*k*) of the definition excludes foreign resource expense (as defined in the definition "foreign resource expense" in subsection 66.21(1)) from FEDE. Foreign resource expense (FRE) covers the same expenditures as FEDE (as amended), except that FRE expenditures are incurred in taxation years that begin after 2000 and FRE expenditures are explicitly linked to a particular country. This amendment applies to taxation years that begin after 2000.

New paragraph (*l*) of the definition excludes expenditures made by a taxpayer after February 27, 2000 unless:

- the expenditure was made pursuant to an agreement in writing made by the taxpayer before February 28, 2000,

- the expenditure was for the acquisition of foreign resource property by the taxpayer, or

- the expenditure was incurred for the purpose of

    - enhancing the value of foreign resource property that the taxpayer owned at the time the expenditure was incurred or that the taxpayer had a reasonable expectation of owning after that time, or

  - assisting in evaluating whether a foreign resource property is to be acquired by the taxpayer.

"original owner"

An "original owner" of a resource property for the purposes of the successor rules in section 66.7 of the Act is defined as a person

- who owned the resource property and disposed of it to a corporation in circumstances where the successor rules apply to the corporation in respect of the property, and
- who would, but for that disposition and the resulting reduction of resource pools available to the person, be entitled in computing income for a taxation year that ends after the disposition to a deduction in respect of the resource expenses incurred by the person prior to the disposition.

This definition is amended to add cross-references to the new rules governing the treatment of foreign resource expenses under subsections 66.21(4) and 66.7(2.3) and (13.1). Similarly, the existing reference to "foreign exploration and development expenses" (as defined in subsection 66(15)) is replaced by a more general reference to "foreign resource pool expenses" (as defined in subsection 248(1)).

This amendment applies to taxation years that begin after 2000.

"predecessor owner"

A "predecessor owner" of a resource property for the purposes of the successor rules in section 66.7 of the Act is defined as a corporation

- that acquired the resource property in circumstances where the successor rules apply to it in respect of the property,
- that disposed of the property to another corporation in circumstances where the successor rules apply to the other corporation in respect of the property, and

- that would, but for the disposition and resulting reduction of successor pools available to the corporation, be entitled in computing its income from the property for a taxation year ending after the disposition to a deduction in respect of the resource expenses incurred by an original owner of the property.

This definition is amended to add cross-references to the new rules governing the treatment of foreign resource expenses under new subsections 66.7(2.3) and (15.1).

This amendment applies to taxation years that begin after 2000.

"specified foreign exploration and development expense"

The new definition "specified foreign exploration and development expense" in subsection 66(15) of the Act provides for a subcategory of FEDE. The definition explicitly links FEDE (determined with reference to the amendments to the definition "foreign exploration and development expenses", described above) to the particular country in which the foreign resource property that relates to a given expenditure is situated. The definition is used in new subsections 66(4.1) and (4.2), amended subsection 66(12.4) and new subsections 66(12.41) and 66.7(2.1) and (2.2). For more detail, see the commentary on subsections 66(4.1) and (4.2).

This definition applies after 1994, given that those subsections can apply from as early as January 1, 1995.

**Other Definitions**

ITA
66(15.1)

Subsection 66(15.1) of the Act provides that the definitions in sections 66.1, 66.2, 66.4 and 66.5 of the Act apply for the purposes of section 66.

Subsection 66(15.1) of the Act is amended so that this measure also applies with regard to the definitions in new section 66.21.

This amendment applies after 2000.

## Members of Partnerships

ITA
66(18)

Existing subsection 66(18) of the Act clarifies the tax treatment of a person (including a partnership) who is a member of a partnership involved in mining or oil and gas. Where a resource expenditure is attributed by the partnership to the member, the member is treated under this provision as having incurred the attributed expenditure at the end of the fiscal period in which that expenditure is incurred by the partnership to the extent that such attributed expenditure is included in the member's foreign exploration and development expense (FEDE), Canadian exploration expense (CEE), Canadian development expense (CDE) or Canadian oil and gas property expense (COGPE).

Subsection 66(18) is amended to provide the same tax treatment with regard to expenses that are a foreign resource expense, as defined in new subsection 66.21(1).

This amendment applies to fiscal periods that begin after 2000.

## Clause 45

## Canadian Exploration Expense

ITA
66.1

Section 66.1 of the Act provides the rules relating to the deduction of "Canadian exploration expense" (CEE) (as defined in subsection 66.1(6)). Specifically, the deduction of CEE is provided for through the concept of "cumulative Canadian exploration expense" (as defined in subsection 66.1(6)) and deductions under subsections 66.1(2) and (3) with respect to cumulative Canadian exploration expense.

## Definitions

ITA
66.1(6)

Subsection 66.1(6) of the Act provides several definitions for the purpose of section 66.1.

"Canadian exploration expense"

Subsections 66.1(2) and (3) of the Act allow a taxpayer a deduction for a taxation year of up to 100 per cent of its cumulative Canadian exploration expense (cumulative CEE) at the end of the year. The definitions of CEE and cumulative CEE are contained in subsection 66.1(6).

Under subparagraph (*d*)(i) of the CEE definition, CEE includes a taxpayer's expenses incurred in a taxation year in drilling or completing an oil or gas well in Canada, provided that the well resulted in the discovery of a natural accumulation of petroleum or natural gas and the discovery occurred within six months after the end of the year. If such a discovery occurs later, subsection 66.1(9) generally allows for the expenditure to be treated as CEE incurred at the time of the discovery.

Subparagraph (*d*)(i) of the CEE definition and paragraph 66.1(9)(*a*) are amended to confirm that the costs of drilling or completing a well qualify as CEE under those provisions only in the event that the drilling or completing of the well resulted in the initial discovery that a natural underground reservoir contains petroleum or natural gas. These amendments apply to expenses incurred after March 1987.

Paragraph (*k*.1) of the CEE definition is introduced to clarify that a taxpayer's CEE does not include the cost to the taxpayer of any depreciable property of a prescribed class. This amendment, as well as the related amendment to the definition "Canadian development expense", is for greater certainty. This amendment applies to property acquired after 1987. Paragraph (*k*.1) complements the wording in existing paragraph (*l*) of the CEE definition, with the result that both paragraphs provide for the same exclusions with regard to application to taxation years that end after December 5, 1996.

In connection with new paragraph (*k*.1), reference should also be made to new subsection 13(34) of the Act.

It should be noted that new paragraph (*k*.1), unlike existing paragraph (*l*), does not explicitly exempt a "Canadian renewable and conservation expense" (CRCE) from being excluded from CEE. The explicit exemption is not considered necessary, since paragraph 1102(1)(*a*.1) of the *Income Tax Regulations* results in any CRCE not being considered to be included in the capital cost of depreciable property.

These amendments apply, with necessary technical modifications to take into account the restructuring of subsection 66.1(6), to the version of the CEE definition in force prior to the enactment of the Revised Statutes of Canada, 1985, Fifth Supplement. Subsection 79(1) of the *Income Tax Application Rules* contains a rule to this effect.

"cumulative Canadian exploration expense"

The description of L, in the formula in the definition "cumulative Canadian exploration expense", provides that the investment tax credit claimed by a taxpayer under subsection 127(5) or (6) of the Act, in a year preceding the taxpayer's taxation year, in respect of a qualified Canadian exploration expenditure reduces the taxpayer's cumulative Canadian exploration expense (CCEE) pool in the taxation year. (The expression "qualified Canadian exploration expense" was previously defined in subsection 127(9). The definition of that expression was repealed by S.C. 1996, c. 21, subsection 30(9), applicable to taxation years that begin after 1995.)

The description of L is amended, after October 17, 2000, to provide that a taxpayer's CCEE is reduced by any investment tax credit claimed by the taxpayer in respect of a flow-through mining expenditure of the taxpayer. (See the commentary on the new definition "flow-through mining expenditure" in subsection 127(9) for further details.) Because the investment tax credit calculation can become circular if the credit were to reduce CCEE in the same year in which the credit is claimed, the description of L requires a reduction of the CCEE in the taxation year following the year in which the credit is claimed.

The amendment to the definition of CCEE applies after October 17, 2000.

### Canadian Development Expenses for Preceding Years

ITA
66.1(9)(*a*)

See the commentary on the amendment to subparagraph (*d*)(i) of the definition "Canadian exploration expense" in subsection 66.1(6) of the Act.

## Clause 46

### Canadian Development Expense

ITA
66.2

Section 66.2 of the Act provides rules relating to the deduction of "Canadian development expense" as defined in subsection 66.2(5).

### Definitions

ITA
66.2(5)

"Canadian development expense"

Subsection 66.2(2) of the Act generally allows a taxpayer a deduction for a taxation year of up to 30 per cent of its cumulative Canadian development expense (cumulative CDE) at the end of the year. The definitions of CDE and cumulative CDE are contained in subsection 66.2(5).

Paragraph (*i*.1) of the CDE definition is introduced to clarify that a taxpayer's CDE does not include the cost to the taxpayer of any depreciable property of a prescribed class. This amendment, as well as the related amendment to the definition "Canadian exploration expense", is for greater certainty.

This amendment applies to property acquired after 1987. Paragraph (*i*.1) complements the wording in existing paragraph (*j*) of the CDE definition, with the result that both paragraphs provide for the same exclusion with regard to application to taxation years that end after December 5, 1996.

This amendment applies, with necessary technical modifications to take into account the restructuring of subsection 66.2(5), to the version of the CDE definition in force prior to the enactment of the Revised Statutes of Canada, 1985, Fifth Supplement. Subsection 79(1) of the *Income Tax Application Rules* contains a rule to this effect.

In connection with new paragraph (*i*.1), reference should also be made to new subsection 13(34) of the Act.

## Clause 47

### Foreign Resource Expense

ITA
66.21

New section 66.21 of the Act sets out the rules governing foreign resource expenses (FRE). The expression "foreign resource expense" in subsection 66.21(1) is defined essentially in the same way as FEDE, except that there are separate FRE accounts in respect of each country to which FRE relates. FRE applies to expenses incurred in taxation years that begin after 2000, although a partner's FRE is determined with reference to partnership fiscal periods that begin after 2000. FRE is explicitly excluded from the amended FEDE definition in subsection 66(15). Section 66.21 is structured as follows:

- subsections 66.21(1) and (2) provide definitions used in section 66.21;
- subsection 66.21(3), in conjunction with paragraph 59(3.2)(*c*.1), provides for an amount to be included in income where there is a "negative" FRE balance;

- subsection 66.21(4) provides for a deduction in respect of the FRE balance for a taxation year. Generally, the deduction cannot exceed 30% of the balance at the end of the year; and

- subsection 66.21(5) provides a special rule for individuals who cease to reside in Canada.

New section 66.21 applies to taxation years that begin after 2000. The structure of section 66.21 and related successor rules in section 66.7 is similar to parallel rules for Canadian development expenses.

**Definitions**

ITA
66.21(1)

New subsection 66.21(1) of the Act sets out a number of definitions.

"adjusted cumulative foreign resource expense"

The "adjusted cumulative foreign resource expense" of a taxpayer in respect of a country at the end of a taxation year is the taxpayer's cumulative foreign resource expense at the end of the year, plus an adjustment that applies in the event that the taxpayer disposes of foreign resource properties in the year in circumstances to which the successor rules in section 66.7 of the Act apply. The purpose of this adjustment is to permit a taxpayer to claim deductions for a taxation year of a succession in respect of foreign resource expenses incurred before the succession occurs, despite the taxpayer's cumulative FRE being reduced to nil under the description of J of the definition "cumulative foreign resource expense" as a consequence of a succession.

This definition is used in subsection 66.21(4). Its effect is illustrated in the example contained in the commentary on new subsections 66.7(13.1) and (13.2).

"cumulative foreign resource expense"

The definition "cumulative foreign resource expense" is essentially the balance of unused FRE, determined as of a particular time. The FRE deduction under subsection 66.21(4) for a taxation year is determined with reference to cumulative FRE at the end of the year. In general, cumulative FRE at any time for a taxpayer in respect of a country is determined as follows:

- [A] ADD the taxpayer's FRE incurred in respect of the country before that time;

- [B] ADD "negative" FRE balances in respect of the country previously included in computing the taxpayer's income;

- [C] ADD bad debt amounts in respect of amounts receivable previously deducted in computing cumulative FRE under the descriptions of F or G (described below);

- [D] ADD specified amounts under subsection 66.7(13.2), representing cumulative FRE in respect of the country not available to a successor after there has been a disposition of foreign resource properties by the taxpayer in circumstances to which the successor rules in section 66.7 apply (See, in this regard, the example in the commentary on subsections 66.7(13.1) and (13.2).);

- [E] SUBTRACT the taxpayer's previous FRE claims in respect of the country;

- [F] SUBTRACT previous proceeds from the disposition of foreign resource properties in respect of the country, to the extent allocated under new subparagraph 59(1)(*b*)(ii). However, in cases where those properties were acquired by the taxpayer in circumstances to which the successor rules apply, proceeds are applied first to reduce unused successor FRE balances under new subsection 66.7(2.3);

- [G] SUBTRACT amounts receivable that enter into the calculation of cumulative FRE in respect of the country because of new subsection 66(12.41);

- [H] SUBTRACT recoveries of bad debts previously reflected as an addition under the description of C;

- [I] SUBTRACT adjustment provided because of the debt forgiveness rules in section 80; and

- [J] where the taxpayer previously disposed of foreign resource properties in circumstances to which the successor rules applied, SUBTRACT the taxpayer's cumulative FRE in respect of the country as of the time of the succession.

In calculating cumulative FRE at any time, the amounts that would otherwise be included in [A] to [J] and that relate to periods of time during which the taxpayer was not resident in Canada are ignored. If a taxpayer had previously been a resident of Canada, ceased to reside in Canada and subsequently becomes a resident in Canada, amounts that would otherwise be included in [A] to [J] and that relate to the previous periods of residence in Canada are likewise ignored.

"foreign resource expense"

See the first paragraph of the commentary on this section.

"foreign resource income"

The new definition "foreign resource income" is structured in a manner similar to that of the foreign resource income limitation provided under amended subparagraph 66(4)(*b*)(ii), except that the new definition applies on a country-by-country basis while subparagraph 66(4)(*b*)(ii) applies to world-wide income. In general terms, the definition refers to a taxpayer's mineral, oil and gas production and royalty income in respect of a country, as well as income from the disposition of foreign resource property in respect of the country. In computing foreign resource income, deductions under subsections 66(4) and 66.21(4) are not taken into account. (However, successor deductions under subsections 66.7(2) and (2.3) are taken into account and can result in a decrease of foreign resource income.)

"foreign resource loss"

The "foreign resource loss" of a taxpayer for a taxation year in respect of a country (other than Canada) is defined as the taxpayer's loss for a taxation year in respect of the country determined in accordance with the definition "foreign resource income", with such modifications as the circumstances require.

The expression "foreign resource loss" is used in new clause 66.21(4)(*a*)(ii)(D).

"global foreign resource limit"

A taxpayer's deduction limit for FRE under new subsection 66.21(4) is determined with reference to the taxpayer's "global foreign resource limit". Without reference to the "global foreign resource limit", a taxpayer cannot deduct in respect of a country more than 30% of the taxpayer's cumulative FRE in respect of the country. In general terms, the definition "global foreign resource limit" and paragraph 66.21(4)(*b*) are structured to permit a taxpayer to deduct a higher amount of the taxpayer's cumulative FRE in respect of a country, provided that on an overall basis the taxpayer claims no more than the lesser of:

- 30% of the taxpayer's total cumulative FRE in respect of all countries; and
- the taxpayer's global foreign resource income determined under subparagraph 66(4)(*b*)(ii), other than the portion of it used to support the taxpayer's deduction under subsection 66(4) or to support total deductions otherwise available under subsection 66.21(4).

## Incorporation of Definitions

ITA
66.21(2)

Subsection 66.21(2) of the Act provides that the definitions in subsection 66(15) apply for the purposes of section 66.21. The relevant definitions include the expressions "foreign resource property", "production" and "drilling or exploration expense".

## Amount to be Included in Income

ITA
66.21(3)

Subsection 66.21(3) of the Act provides for an amount to be included in computing a taxpayer's income for a taxation year where there is a "negative" FRE balance. In the event that the taxpayer disposes of foreign resource properties in the year in circumstances in which the successor rules apply, the income inclusion is offset by the taxpayer's

FRE balance immediately before the succession (other than the portion of the balance that the taxpayer has made exclusively available to the successor because of a designation under subparagraph 66.7(13.2)(*a*)(ii)).

## Deduction for Cumulative Foreign Resource Expense

ITA
66.21(4)

Subsection 66.21(4) of the Act permits a deduction in respect of a taxpayer's cumulative FRE in respect of each country. The deduction for a taxation year is generally available only to persons resident in Canada throughout the year. See, however, subsection 66.21(5) (application of subsection 66.21(4) to part-year residents) and new paragraph 115(1)(*e*.1) (FRE deduction for non-residents).

The limit of the permitted deduction is determined in accordance with subsection 66.21(4). The limit is not less than 10% of the taxpayer's cumulative FRE in respect of the country at the end of a taxation year and, in all cases, is not more than the full amount of the balance. Cumulative FRE for this purpose is adjusted, as explained in the commentary on the definition "adjusted cumulative foreign resource expense".

Subject to paragraph 66.21(4)(*b*) and the 10% minimum limit, the maximum that a taxpayer may deduct in computing income for a taxation year in respect of a country is generally an amount that does not exceed the least of

- the amount of the taxpayer's "foreign resource income" in respect of the country,
- 30% of the taxpayer's adjusted cumulative FRE at the end of the year,
- the amount determined by clause 66.21(4)(*a*)(ii)(C), and
- the amount determined by clause 66.21(4)(*a*)(ii)(D).

In connection with clause 66.21(4)(*a*)(ii)(C), see the commentary on new subsections 66(4.1) and (4.2).

With regard to the defined expression "foreign resource income", see the commentary on the expression "foreign resource income" in subsection 66.21(1).

Paragraph 66.21(4)(*b*) permits, in some cases, a taxpayer to deduct a higher amount from the taxpayer's cumulative FRE in respect of a country than would otherwise be the case. The additional deduction is equal to the lesser of:

- the amount by which the taxpayer's cumulative FRE in respect of the country at the end of the year exceeds the portion of it that would otherwise be deductible under subsection 66.21(4) in computing the taxpayer's income for the year; and
- the portion of the taxpayer's "global foreign resource limit" designated by the taxpayer in respect of the country.

The effect of paragraph 66.21(4)(*b*) is to permit a taxpayer to deduct an additional amount of the taxpayer's cumulative FRE in respect of a country beyond the 10% or 30% limit set out in paragraph 66.21(4)(*a*). The additional amount is determined with reference to a taxpayer's "global foreign resource limit" (as described in the commentary above), which is intended to allow additional deductions in order to permit a taxpayer to use, in aggregate, up to 30% of the taxpayer's total cumulative FRE in respect of all countries to the extent that there is sufficient supporting global foreign resource income.

As provided in subsection 66.21(4), FEDE claims by a taxpayer may affect the amount of permitted deduction in respect of cumulative FRE.

### Individual Changing Residence

ITA
66.21(5)

Subsection 66.21(5) of the Act applies where an individual becomes, or ceases to be, resident in Canada in a taxation year.

Under section 128.1, the immigration or emigration of an individual (other than a trust) has no impact on an individual's taxation year.

Consequently, the individual would be resident in Canada for part of the taxation year and not resident in Canada for another part, with the result that, absent subsection 66.21(5), the individual would otherwise not be permitted to deduct an amount for the year under subsection 66.21(4). (This is because subsection 66.21(4) provides that, for a taxpayer to claim a deduction under that subsection for a taxation year, the taxpayer must be resident in Canada throughout the year.) Furthermore, the wording of section 114 that applies to the 1998 and subsequent taxation years would, absent subsection 66.21(5), preclude an individual who is resident in Canada for only part of a taxation year from obtaining a deduction in the year in respect of cumulative FRE.

Consequently, subsection 66.21(5) provides that, for the purposes of subsection 66.21(4), a part-year resident's taxation year is treated as being the part of the taxation year throughout which the individual is resident in Canada and that, for these purposes, subsection 66(13.1) (which provides a rule relating to proration of deductions for short taxation years) does not apply to the individual for the year. As a result, an individual who is resident in Canada for only part of a taxation year can claim a non-prorated deduction under subsection 66.21(4). The deduction determined in this manner enters into the calculation of the individual's taxable income pursuant to section 114.

Given that section 128.1 operates to create new taxation years for trusts or corporations that become or cease to be resident in Canada, this measure has no relevance to trusts and there is no need to extend this measure to apply to corporations. Subsection 66.21(5) is parallel to new subsection 66(4.3), described in the commentary above.

Subsection 66.21(5) provides that, in this case, the individual's taxation year for the purposes of subsection 66.21(4) is considered to be the period or periods throughout which the individual is resident in Canada. The deduction determined in this manner enters into the calculation of the individual's taxable income pursuant to section 114.

## Clause 48

### Definitions

ITA
66.4(5)

"disposition"

Subsection 66.4(5) of the Act defines the expressions "disposition" and "proceeds of disposition" for the purposes of section 66.4. These expressions are defined in the same way as they are defined in section 54.

Subsection 66.4(5) is amended to eliminate the references to the expression "disposition", as this expression is now defined in subsection 248(1).

This amendment applies to transactions and events that occur after December 23, 1998.

## Clause 49

### Exploration and Development Expenses – Successor Rules

ITA
66.7

Section 66.7 of the Act provides rules (commonly known as the "successor rules") relating to the deduction, by a "successor corporation", of unused resource expenses of another person in respect of resource properties acquired by the successor corporation.

### Country-by-Country Successor FEDE Allocations

ITA
66.7(2)(*a*)(i)

Subsection 66.7(2) allows a corporation to claim deductions with respect to foreign exploration and development expenses (FEDE) incurred by one or more original owners, where property has been acquired in circumstances to which the successor rules apply.

Subparagraph 66.7(2)(*a*)(i) is amended so that the successor FEDE that may be deducted by a successor corporation in respect of an original owner's FEDE is limited to FEDE incurred while the original owner was resident in Canada. This change is parallel to the amendment, described above, to subparagraph 66(4)(*a*)(i).

This amendment applies to the 1999 and subsequent taxation years.

ITA
66.7(2.1) and (2.2)

Under existing subsection 66.7(2) of the Act, successor FEDE in respect of one country is not distinct from successor FEDE in respect of another country.

New subsection 66.7(2.1) provides that, to the extent that a successor FEDE deduction under subsection 66.7(2) can reasonably be considered to be in respect of "specified foreign exploration and development expenses" (as newly defined in subsection 66(15)) in respect of a country, for greater certainty that portion of the successor FEDE deduction is considered to apply to a source in that country. As a consequence, that portion of the successor FEDE deduction can result in a reduction of the limit for the taxpayer's foreign tax credit under section 126 in respect of the country and, pursuant to clause 66.21(4)(*a*)(ii)(C) or (D), can also result in a reduction of the limit for the taxpayer's deduction of foreign resource expenses under new section 66.21.

New subsection 66.7(2.2) elaborates on how an allocation to a country is made under subsection 66.7(2.1). The method of allocation must be reasonable in the circumstances and be consistently applied from year to year.

New subsections 66.7(2.1) and (2.2) are analogous to new subsections 66(4.1) and (4.2), described in the commentary above.

These amendments apply to taxation years that begin after 1999. However, in the event that a taxpayer elects to have the new foreign tax credit provisions under section 126 apply to taxation years that begin after an earlier date (but not earlier than December 31, 1994) designated by the taxpayer, these amendments apply on the same basis.

## Successor of Foreign Resource Expenses

ITA
66.7(2.3)

New subsection 66.7(2.3) of the Act provides for the transfer of an original owner's unused foreign resource expense (FRE) balance, on an acquisition of foreign resource properties in circumstances to which the successor rules apply. Subsection 66.7(2.3) is structured much like the deduction under subsection 66.7(4) for a successor of Canadian development expenses, in that proceeds from the disposition of such foreign resource properties are generally applied to reduce the successor FRE balance. The amount by which a successor FRE balance is reduced offsets the amount of reduction otherwise required under subsection 66.21(1) to the successor's own cumulative FRE.

The unused amount of a successor FRE balance may be deducted against "streamed income" (as determined under subparagraph 66.7(2.3)(*b*)(i)) in respect of the foreign resource properties acquired on the succession. This subparagraph refers only to income from production, not to proceeds of disposition, given the treatment of proceeds described immediately above. Under subparagraph 66.7(2.3)(*b*)(ii), any "streamed income" from Canadian resource properties acquired with such foreign resource properties on a succession can be used to support additional successor FRE deductions required in order for the successor to claim up to 10% of the successor FRE balance in a taxation year. Subparagraph 66.7(2.3)(*b*)(ii) is consistent with subparagraph 66.7(2)(*b*)(ii), and ensures that the 10% minimum relating to maximum deductions with regard to FEDE or FRE is not lost on a succession involving a mixture of Canadian and foreign resource properties if there is sufficient overall foreign and Canadian resource income to support the 10% minimum. However, any "streamed income" can only be used once in determining the level of deductions to which a taxpayer is entitled under subsection 66.7(2) or (2.3). In addition, deductions under those subsections can limit the extent to which a taxpayer can claim deductions under subsections 66(4) and 66.21(4).

The operation of subsection 66.7(2.3) and related provisions are illustrated in the example below.

***Example***

*ABC Corp. has an outstanding successor FEDE pool of $30,000, an outstanding successor FRE pool of $20,000, a FEDE balance in its own right of $70,000 and cumulative FRE of $40,000. In 2001, ABC disposes of all its foreign resource properties acquired on the succession for $145,000. ABC designates $60,000 under subparagraph 59(1)(b)(ii), so that the amount included in its income under subsection 59(1) is $85,000. There are no relevant transactions or events after the succession, and no relevant production income in 2001. ABC uses calendar years as its taxation years.*

*Results:*

*1. ABC is permitted to deduct the full amount ($30,000) of its successor pool under subsection 66.7(2) for its 2001 taxation year. For this purpose, ABC's streamed income is equal to the $85,000 included under subsection 59(1) in computing ABC's income.*

*2. No deduction is permitted under subsection 66.7(2.3), because the $60,000 designated amount reduces the successor FRE pool under subparagraph 66.7(2.3)(a)(ii). Instead, under paragraph (b) of the description of F in the definition "cumulative foreign resource expense" in subsection 66.21(1), the resulting $20,000 grind to the successor FRE pool offsets the amount by which ABC's own cumulative FRE is required to be reduced.*

*3. ABC will therefore not be entitled to deduct any amount under subsection 66.21(4) for its 2001 taxation year because its cumulative FRE is nil (i.e., ($40,000 – ($60,000 - $20,000)) at the end of the year. For the same reason, ABC's income inclusion under subsection 66.21(3) for the year is nil.*

*4. The amount deductible by ABC under subsection 66(4) for the year is equal to $55,000, which is the lesser of:*

- *$70,000 (subparagraph 66(4)(b)(i)), and*

- *$85,000 (subsection 59(1) and subclause 66(4)(b)(ii)(C)(I)), minus $30,000 (subclause 66(4)(b)(ii)(C)(II)).*

*5. As a consequence, $15,000 of FEDE remains available for deduction in a subsequent year or years.*

*6. The following table summarizes these results*

| ***A. Pool*** | ***B. Pool amount*** | ***C. Portion of "B" used*** |
|---|---:|---:|
| *successor FEDE* | *$30,000* | *$30,000* |
| *successor FRE* | *$20,000* | *$20,000* |
| *FEDE balance* | *$70,000* | *$55,000* |
| *cumulative FRE* | *$40,000* | *$40,000* |
| *TOTAL* | *$160,000* | *$145,000* |

New subsection 66.7(2.3) applies to taxation years that begin after 2000.

## Application of subsections (2) and (3) – Restrictions with Regard to the Applicability of the Successor Rules

ITA
66.7(8)

Subsection 66.7(8) of the Act generally provides a restriction under which the successor rules for FEDE in subsection 66.7(2) apply only with regard to acquisitions by a corporation of all or substantially all of the foreign resource properties of another person.

Subsection 66.7(8) is amended to include a reference to new subsection 66.7(2.3), so that the same restriction applies with regard to the successor rules for FRE in new subsection 66.7(2.3).

This amendment applies to taxation years that begin after 2000.

**Change of Control**

ITA
66.7(10)

Under subsection 66.7(10) of the Act, a corporation is treated as a successor for the purposes of the successor rules in section 66.7 after an acquisition of control (or a change in the tax-exempt status) of the corporation.

The portion of this subsection between paragraphs (*b*) and (*c*) is also amended to replace a reference to foreign exploration and development expenses with a more general reference to foreign resource pool expenses, as defined in subsection 248(1).

This amendment applies to taxation years that begin after 2000.

ITA
66.7(10)(*f*)

Under subsection 66.7(10) of the Act, a corporation is treated as a successor for the purposes of the successor rules in section 66.7 after an acquisition of control of the corporation. Under paragraph 66.7(10)(*e*), resource expenses incurred by the corporation prior to the change of control are deemed to have been incurred by an original owner of resource properties owned at the time of the acquisition of control.

New paragraph 66.7(10)(*f*) ensures that the deemed original owner had the same status with regard to residence in Canada before the acquisition of control of a corporation as the corporation itself. This amendment is consequential to an amendment, described above, to subparagraph 66.7(2)(*a*)(i) affecting successor FEDE claims.

This amendment applies to the 1999 and subsequent taxation years.

### Change of Control (Special Rules relating to Parent-Subsidiary Income Allocations)

ITA
66.7(10)(*h*)

Where control of a parent corporation is acquired at a time when it owns foreign resource property, and a subsidiary wholly-owned corporation of the parent had incurred foreign resource expenses before that time, paragraph 66.7(10)(*h*) of the Act generally allows the parent to designate in favour of the subsidiary any portion of its income for the year attributable to the production from such foreign resource properties. After the designation, the amount designated will, for the purpose only of claiming a deduction under the successor rules, be treated as production income of the subsidiary and not of the parent from foreign properties owned by it before the acquisition of control. In the situation where the subsidiary, rather than the parent, owns the foreign resource property after an acquisition of control this paragraph also allows the subsidiary to designate amounts in favour of its parent.

Paragraph 66.7(10)(*h*) is amended to permit designations of foreign production income to enable greater deductions to be claimed under new subsection 66.7(2.3) by the subsidiary or the parent, as the case may be.

This amendment applies to taxation years that begin after 2000.

### Change of Control (Special Rules relating to Partnership Members)

ITA
66.7(10)(*j*)

Where control of a corporation is acquired and, at the time of the acquisition of control, the corporation was a member of a partnership, paragraph 66.7(10)(*j*) of the Act treats the corporation as owning, immediately before the acquisition of control, a portion of the resource property owned by the partnership at the time of the acquisition of control. The portion is equal to the corporation's percentage share of all amounts that would be paid to all members of the partnership if the partnership were wound up at the time of the acquisition of control. In the event of a sale of these properties, the corporation would treat the proceeds as being from a disposition of resource properties owned before the acquisition of control. As a consequence, the corporation can have higher levels of "streamed income" against which to claim specified successor deductions under section 66.7.

Paragraph 66.7(10)(*j*) is amended so that successor deductions under new subsection 66.7(2.3) are likewise specified for this purpose. This amendment is consequential to the introduction of new rules for the deduction of foreign resource expenses and successor foreign resource expenses under new subsections 66.21(4) and 66.7(2.3).

This amendment applies to taxation years that begin after 2000.

### Tax Consequences to Original Owner

ITA
66.7(13.1) and (13.2)

New subsection 66.7(13.1) of the Act sets out the tax consequences to an original owner of foreign resource properties who disposes of the properties in circumstances to which new subsection 66.7(2.3) applies. This subsection is structured in a manner similar to paragraphs 66.7(12)(*c*) and (*c*.1), both of which relate to successor Canadian development expense. For the purposes of the commentary below it is assumed that an original owner is party to only one transaction in a taxation year as a consequence of which its cumulative FRE is subject to the successor rules.

Under paragraph 66.7(13.1)(*a*), the original owner's cumulative FRE is reduced immediately after the succession to nil. See also in this regard the description of J in the definition "cumulative foreign resource expense" in subsection 66.21(1).

The part of the successor FRE balance considered to have been deducted by the original owner (and, as a consequence, not available to the successor) in connection with a transfer, to which new subsection 66.7(2.3) applies, at any time by the original owner is generally the specified amount determined under subsection 66.7(13.2). That subsection is parallel to paragraph 66.7(12.1)(*b*), which relates to Canadian development expenses. The specified amount determined under subsection 66.7(13.2) represents the portion of the successor FRE balance that the original owner:

- used under paragraph 66.21(3)(*c*) in order to offset an income inclusion under paragraph 59(3.2)(*c*.1); or

- deducted under subsection 66.21(4), because of the adjustments provided under the definition "adjusted cumulative foreign resource expense" in subsection 66.21(1).

Under subparagraph 66.7(13.2)(*a*)(ii), the original owner can elect to reduce or eliminate its specified amount so that the full amount of (or a higher portion of) the original owner's cumulative FRE at the time of a succession is available to the successor.

The example below illustrates the operation of subsections 66.7(13.1) and (13.2) and related provisions.

***Example***

*XYZ Corp. transfers all of its foreign resource properties in 2003 to Newco in circumstances to which the successor rules in section 66.7 apply. Before the transfer, XYZ's cumulative foreign resource expense (cumulative FRE) is $100,000. The proceeds of disposition of the foreign resource properties are $40,000. XYZ wants to deduct the maximum amount it can under subsection 66.21(4) for the year of the succession. XYZ incurs no further FRE after the succession, has no foreign resource production income in the year of succession and, after the succession, disposes of no foreign resource properties.*

*Results:*

*1. The potential successor FRE pool available to Newco is $60,000 (i.e., $100,000 minus $40,000). See, in this regard, the description of F in the definition "cumulative foreign resource expense" in subsection 66.21(1) and subparagraph 66.7(2.3)(a)(i). However, this potential FRE pool is reduced to the extent that XYZ claims a deduction in respect of the pool for the year of the succession.*

*2. XYZ's deduction under subsection 66.21(4) for the year of succession is computed with reference to its adjusted cumulative FRE under subsection 66.21 (1). This amount is computed by totalling:*

- *XYZ's cumulative FRE at the end of the succession year (i.e. $100,000 (A, E) - $40,000 (F) - $60,000 (J)), which is nil; and*

- *the amount determined under paragraph 66.7(13.2)(a), which is $60,000. (It is assumed that XYZ designates no amount under subparagraph 66.7(13.2)(a)(ii). XYZ would only designate an amount under that subparagraph if it is willing to limit its ability to claim FEDE in the succession year.)*

*3. XYZ claims $6,000 under subsection 66.21(4) for the year of succession.*

*4. Immediately after the end of the year of succession, XYZ's cumulative FRE is nil. This is equal to nil (balance at end of the year of the succession), plus $6,000 (D – which is equal to the amount determined under subsection 66.7(13.2)), minus $6,000 (E – representing deductions under subsection 66.21(4)).*

*5. As a consequence of XYZ's claim, clause 66.7(2.3)(a)(i)(A) and paragraph 66.7(13.1)(b), the successor FRE pool actually available to Newco is $54,000.*

New subsections 66.7(13.1) and (13.2) apply to taxation years that begin after 2000.

### Tax Consequences to Predecessor Owners

ITA
66.7(15.1)

New subsection 66.7(15.1) of the Act provide rules for predecessor owners similar to those in subsections 66.7(13.1) and (13.2) that apply to original owners. (A "predecessor owner" of resource properties is a corporation that acquires resource properties in circumstances to which the successor rules apply and subsequently disposes of resource properties in circumstances to which the successor rules apply.) Under paragraph 66.7(15.1)(*a*), where a predecessor owner of foreign resource properties disposes of all or substantially all of its foreign resource properties in circumstances in which the successor rules apply, it is generally treated after the disposition as never having acquired the properties in respect of which the successor rule applied. As a consequence, the predecessor is generally precluded from claiming successor FRE deductions after the subsequent succession. Subsection 66.7(15.1) is structured in a manner that is similar to that of subsection 66.7(14).

In the case of arm's length dispositions or dispositions by way of amalgamation or merger, notwithstanding the general rule in paragraph 66.7(15.1)(*a*) the predecessor owner is allowed to claim deductions under subsection 66.7(2.3) (dealing with an original owner's foreign resource expenses) for the taxation year of the disposition. In addition, subparagraph 66.7(15.1)(*a*)(ii) ensures that paragraph 66.7(15.1)(*a*) does not have a retrospective negative impact on the value of F in the definition "cumulative foreign resource expense" in subsection 66.21(1) in respect of the predecessor owner.

Paragraph 66.7(15.1)(*b*) ensures that proceeds that subsequently become receivable by a predecessor owner will not affect the calculation of the portion of an original owner's cumulative FRE available to a subsequent successor.

New subsection 66.7(15.1) applies to taxation years that begin after 2000.

## Incorporation of Definitions

ITA
66.7(18)

Subsection 66.7(18) of the Act provides that the definitions in subsection 66(15) apply to section 66.7.

Subsection 66.7(18) is amended to clarify that the definitions in sections 66.1 to 66.4, including new section 66.21, also apply to section 66.7.

This amendment applies to taxation years that begin after 2000.

## Clause 50

### Resource Expenses of a Limited Partner

ITA
66.8(1)

Subsection 66.8(1) of the Act provides for the reduction of a taxpayer's share of a partnership's resource expenditures incurred in a fiscal period in certain cases where the taxpayer's share of such resource expenditures exceeds the taxpayer's "at-risk amount" at the end of the fiscal period in respect of the partnership. Where there is such a reduction, subsection 66.8(2) allows the amount of the reduction to be carried forward and treated as if it were a resource expenditure incurred in the following fiscal period. The reduction of the taxpayer's resource expenditures occurs in a specified order, with a taxpayer's share of foreign exploration and development expenses being the last type of resource expenditure that is reduced.

Subsection 66.8(1) is amended so that a taxpayer's share of expenses that are a foreign resource expense in respect of a country (as defined in new section 66.21) is likewise reduced. Given the greater restrictions on the use of such expenses, the reduction is applied first to such expenses before being applied to foreign exploration and development expenses. In the event that the partnership incurred foreign resource expenses in respect of more than one country, the taxpayer can choose which country's foreign resource expenses are reduced. The Minister of National Revenue chooses the order in the event that no specification is made by the taxpayer on a timely basis.

This amendment applies to fiscal periods that begin after 2000.

## Clause 51

### Non-Arm's Length Transactions

ITA
69

Section 69 of the Act provides a series of rules that deal primarily with transactions entered into between non-arm's length persons or on non-arm's length terms.

ITA
69(1)(*b*) and (*c*)

Subsection 69(1) of the Act provides rules that deal with gifts and non-arm's length dispositions of property, except where such transactions are covered by other express provisions in the Act (e.g., section 85, subsections 107(2) and (2.1) and new subsection 107.4(3)). Under paragraph 69(1)(*b*), a taxpayer is deemed to receive proceeds of disposition equal to the fair market value of the property disposed of where the taxpayer disposed of the property by way of gift or to a non-arm's length person for proceeds less than the fair market value of the property. Under paragraph 69(1)(*c*), a taxpayer who has acquired property by way of gift, bequest or inheritance is deemed by paragraph 69(1)(*c*) to have acquired the property at its fair market value.

Paragraph 69(1)(*b*) is amended to ensure that, subject to subsection 107.4(3), it applies to a disposition to a trust of a property where no change in the beneficial ownership of the property is involved.

Paragraph 69(1)(*c*) is amended so that a taxpayer, where subsection 69(1) applies, is also considered to acquire property at its fair market value where the acquisition is because of a disposition that does not result in any change in the beneficial ownership of the property.

For a description of circumstances where a transfer without any change in beneficial ownership is not a "disposition", reference should be made to the commentary on the new definition "disposition" in subsection 248(1).

These amendments apply after December 23, 1998.

### Inadequate Considerations

ITA
69(5)(*c*)

Subsection 69(5) of the Act ensures that where property is appropriated by a shareholder on the winding-up of a corporation, the property is treated as having been transferred at its fair market value with the consequent recognition on the transfer of any resulting income or loss. For this purpose, paragraph 69(5)(*c*) provides that subsections 52(1), (1.1) and (2) do not apply for the purposes of determining the cost to the shareholder of the property transferred.

Paragraph 69(5)(*c*) is amended to remove the reference to subsection 52(1.1), consequential to the repeal of that subsection.

This amendment applies to dispositions that occur after 1999.

## Clause 52

### Death of a Taxpayer

ITA
70(5.1)(*d*)

Subsection 70(5.1) of the Act deals with the transfer of a taxpayer's eligible capital property to a beneficiary on death.

Paragraph 70(5.1)(*d*), which deals with the beneficiary's gains in respect of the eligible capital property after the death of the taxpayer, is amended consequential to the re-numbering of subsection 14(1) of the Act, which is described in further detail in the commentary to that subsection.

This amendment applies to taxation years that end after February 27, 2000.

ITA
70(5.2)

Subsection 70(5.2) of the Act provides rules in respect of the disposition of resource properties and land inventories on death. Under paragraph 70(5.2)(*a*), foreign resource properties and Canadian resource properties are deemed for specified purposes to have been disposed of at fair market value immediately before the taxpayer's death. However, paragraph 70(5.2)(*b*) generally overrides paragraph 70(5.2)(*a*) in connection with property transferred or distributed to a spouse, a common-law partner or a joint spousal or common-law partner trust. Where this is the case, the taxpayer's legal representative can elect that an amount be the proceeds of disposition (to the taxpayer), and the acquisition cost (to the spouse, common-law partner or trust) of such a property. The elected amount cannot exceed the property's fair market value immediately before death. The elected amount is considered to be the proceeds of disposition and acquisition cost, respectively, of the property, to the extent that the elected amount is reflected in an amount included in computing the taxpayer's income under subsection 59(1) (in the case of foreign resource property) or in an amount that reduces the taxpayer's cumulative Canadian development expense (in the case of Canadian mining property) or the taxpayer's cumulative Canadian oil and gas property expense (in the case of Canadian oil and gas property).

Paragraph 70(5.2)(*a*) is amended so that it applies for all purposes, including new section 66.21 which deals with the calculation of a taxpayer's deductions and income inclusions in respect of foreign resource expenses.

Paragraph 70(5.2)(*a*.1) is introduced to ensure that, subject to paragraph 70(5.2)(*b*), the acquisition cost, to a taxpayer, of a resource property acquired by the taxpayer on the death of an individual, is considered to be equal to the fair market value of the property at the time of death. This amendment applies to acquisitions that occur after 1992 and is consistent with the wording in paragraph 70(5)(*b*).

Subparagraph 70(5.2)(*b*)(ii) is amended so that the acquisition cost determined under paragraph 70(5.2)(*b*) is equal to the elected amount determined under subparagraph 70(5.2)(*b*)(i). The existing restriction with regard to foreign resource property is not appropriate in light of new subparagraph 59(1)(*b*)(ii). This amendment applies to taxation years that begin after 2000.

Paragraph 70(5.2)(*c*.1) of the Act is introduced to ensure that, subject to subparagraph 70(5.2)(*d*)(ii), the acquisition cost to a taxpayer of land inventory acquired by the taxpayer on the death of an individual is considered to be equal to the fair market value of the property at the time of the individual's death. This amendment applies to acquisitions that occur after 1992.

ITA
70(5.3)

Subsection 70(5) of the Act provides for the deemed disposition of a taxpayer's capital property on the taxpayer's death for proceeds equal to the property's fair market value immediately before the death. In the event that the property includes shares and there was a life insurance policy under which the taxpayer's life was insured, the fair market value of the shares is determined under subsection 70(5.3) as if the value of the policy were the policy's cash surrender value immediately before the taxpayer's death. The purpose of subsection 70(5.3) is to ensure that life insurance proceeds payable as a consequence of death are not reflected in share value and therefore do not give rise to a capital gain on death.

Existing subsection 104(4) provides, in certain cases specified, for a deemed disposition of capital property (which includes shares) on the death of a taxpayer for proceeds equal to the property's fair market value. Existing section 128.1 also provides, in certain cases, that property (including shares) is deemed to be disposed of by an individual for its fair market value in the event that the individual becomes or ceases to be resident in Canada.

Subsection 70(5.3) is amended so that it applies for the purposes of subsection 104(4) and section 128.1.

Subsection 70(5.3) is also amended so that it applies in respect of property deemed to be disposed of as a consequence of a particular individual's death or change of residence where the relevant insurance policy insures the life of another individual (e.g., the spouse or common-law partner of the particular individual) with whom the particular individual does not deal at arm's length.

As a consequence of these amendments, where property is deemed by subsection 104(4) to have been disposed of by a trust as a consequence of the death of a particular individual and there is a life insurance policy under which the particular individual's life (or the life of an individual with whom the particular individual does not deal at arm's length) is insured, the fair market value of the property is determined for the purposes of subsection 104(4) as if the value of the policy were the policy's cash surrender value immediately before the death. Similarly, where property is deemed by section 128.1 to have been disposed of by a particular individual as a consequence of the particular individual becoming or ceasing to be resident in Canada and there is a life insurance policy under which the particular individual's life (or the life of an individual with whom the particular individual does not deal at arm's length) is insured, the fair market value of the property is determined for the purposes of section 128.1 as if the value of the policy were the policy's cash surrender value immediately before the particular individual became or ceased to be resident in Canada.

Subsection 70(5.3) is also amended so that it applies in determining the fair market value of any property (e.g., an interest in a trust or a partnership), not just shares.

Subsection 70(5.3) is further amended to remove references to former subsections 70(9.4) and (9.5), given that these subsections have been repealed.

These amendments apply to dispositions that occur after October 1, 1996.

### Transfer to Children of Settlor

ITA
70(9.1) and (9.3)

Subsections 70(9.1) and (9.3) of the Act permit farm property (including shares of, or interests in, family farm corporations and family farm partnerships) to be disposed of on a rollover basis from a trust created by an individual for the benefit of the individual's spouse or common-law partner to the children of the individual.

Subsections 70(9.1) and (9.3) are amended to preserve the existing rollover. These amendments are consequential to changes to the rules in subsection 73(1) that govern rollovers to trusts for the benefit of a spouse or common-law partner.

These amendments generally apply to dispositions that occur after 1999.

These amendments also reflect changes effected by the *Modernization of Benefits and Obligations Act*.

## Clause 53

### *Inter Vivos* Transfers by Individuals

ITA
73(1) to (1.02)

Subsection 73(1) of the Act generally provides for a tax-free disposition of capital property where it is transferred by an individual to the individual's spouse, common-law partner or a trust for the exclusive benefit of the spouse or common-law partner during the lifetime of the spouse or common-law partner. For subsection 73(1) to apply, the transferor and transferee must both be resident in Canada (determined without reference to subsection 94(1) as it read before 2002) at the time of the transfer. Provision is made to elect out of the rollover rule, in which case the proceeds of disposition for the transferor would be deemed by subsection 69(1) to be the fair market value of the property transferred. Where there has been a transfer to a trust for the benefit of a spouse or common-law partner, subsections 104(4) and 107(4) ensure that capital gains are appropriately recognized by a deemed disposition of trust property at either the time of the death of the spouse or common-law partner beneficiary or, where applicable, at the time of any earlier distribution to another beneficiary.

Subsection 73(1) is amended, in conjunction with the introduction of subsection 73(1.01), so that the current rules in subsection 73(1) for transfers by an individual to a trust are extended to similarly allow for a tax-free disposition where:

- the individual transfers property to a trust for the exclusive benefit of the individual during the individual's own lifetime (such a trust will generally be an "*alter ego* trust", as defined in subsection 248(1), in the event that the individual is at least 65 years of age), or

- the individual transfers the property for the joint benefit of the individual and the individual's spouse or common-law partner during their lifetimes (such a trust will generally be a "joint spousal or common-law partner trust", as defined in subsection 248(1), in the event that the individual is at least 65 years of age). This can involve either equal or unequal entitlements of the two spouses or common-law partners to trust income (as defined in subsection 108(3)).

However, new subsection 73(1.02) limits the application of subsection 73(1.01). It provides that, in order for subparagraphs 73(1.01)(*c*)(ii) and (iii) to apply to a transfer of property by an individual to a trust, the following conditions must be met:

- the trust was created after 1999;

- the individual has attained 65 years of age at the time the trust was created, except where (as provided in subparagraph 73(1.02)(*b*)(ii)) the transfer of property involves no change in beneficial ownership of the property and no person (other than the individual) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)); and

- in the case of a trust to which the individual transfers property for the exclusive benefit of the individual during the individual's own lifetime, the trust does not make an election under subparagraph 104(4)(*a*)(ii.1). For more information on this election see the commentary below on amended paragraph 104(4)(*a*).

The purpose of the "age 65" condition (above and in amended subsection 104(4)) is to limit the opportunity to engage in tax planning involving trusts and the maximization of the deferral of the recognition of capital gains. For example, a 66-year old parent might arrange for common shares of a private corporation to be issued to his or her 27-year old child with the understanding that those common shares be transferred by the child into a trust effectively controlled by the parent that provides for beneficiaries after the child's death. The purpose of this arrangement may, in part, be to minimize capital gains otherwise recognized on the death of the parent. In these circumstances, the transfer by the child to the trust cannot be made on a rollover basis and subsection 104(4) generally provides for a deemed disposition on the 21st anniversary of the trust (rather than on the child's death).

For the purpose of the conditions in subparagraph 73(1.02)(*b*)(ii), no change in beneficial ownership would be expected to result from a transfer of property to a trust where the power to appoint beneficiaries under the trust is reserved by the contributor and is a general power of appointment.

Changes to subsections 104(4) and (6) and 107(4), as described in the commentary below, have been made so that the income tax regime for trusts to which transfers have been made under amended section 73 parallels the existing rules for trusts.

These amendments generally apply to transfers that occur after 1999.

These amendments also reflect changes effected by the *Modernization of Benefits and Obligations Act.*

## Interpretation

ITA
73(1.1)

Subsection 73(1.1) of the Act generally provides that one individual is considered to have transferred property to another individual where the other individual obtains the property under provincial law or because of a decree, order or judgment of a competent tribunal made in accordance with that law. The rule applies for the purpose of the rollover rule in subsection 73(1).

Subsection 73(1.1) is amended to change a number of cross-references, to reflect amended subsection 73(1) and new subsection 73(1.01) (described in the commentary above).

This amendment applies to transfers that occur after 1999.

## Clause 54

### Attribution Rules

ITA
74.2(3) and (4)

Section 74.2 of the Act attributes to an individual taxable capital gains and allowable capital losses realized by the individual's spouse or common-law partner on the disposition of property that was loaned or transferred by the individual to or for the benefit of the individual's spouse or common-law partner, or someone who has since become the individual's spouse or common-law partner.

If the individual's spouse or common-law partner emigrates from Canada after having received the property, an accrued gain or loss on the property that is deemed to be realized by the spouse or common-law partner under paragraph 128.1(4)(*b*) of the Act could be attributed to the individual, resulting in anomalies in the application of the post-emigration loss rules under subsection 128.1(8) of the Act and the security rules under subsection 220(4.5) of the Act. To prevent such anomalies, new subsection 74.2(3) of the Act provides that the attribution rule in subsection 74.2(1) does not apply to the deemed disposition under paragraph 128.1(4)(*b*) unless the individual and the individual's spouse or common-law partner jointly elect, in their tax returns for the taxation year during which the spouse or common-law partner disposes of the property for the first time after emigration, that the rule apply to the deemed disposition.

New subsection 74.2(4) of the Act allows any assessment of tax to be made that is necessary for the joint election to be taken into account, but provides that no such assessment shall affect the computation of interest or penalties payable.

New subsections 74.2(3) and (4) apply after October 1, 1996.

## Clause 55

### Trusts

ITA
75(2)

Subsection 75(2) of the Act generally provides for the attribution of income from a trust property to a person resident in Canada where that property was received by the trust from the person and can revert to the person (or pass to other persons determined by that person).

Subsection 75(2) is amended to clarify that the reference to "person" in the provision includes a corporation.

This amendment applies to taxation years that begin after 2000.

ITA
75(3)(*a*) and (*b*)

Subsection 75(3) of the Act exempts certain trusts from the application of subsection 75(2), which generally provides for the attribution of income from a trust property to a person resident in Canada where that property was received by the trust from the person and can revert to the person (or pass to other persons determined by that person).

Paragraph 75(3)(*a*) is amended to extend the exemption to trusts governed by retirement compensation arrangements (as defined in subsection 248(1)). These trusts are subject to tax in the hands of the trustee under Part XI.3. This amendment ensures that these trusts will not also be subject to tax under Part I in the hands of a person (typically an employer) who made contributions to the trust. This amendment applies to taxation years ending after October 8, 1986, the date on which the retirement compensation arrangement rules were originally announced.

Paragraph 75(3)(*b*) is amended to extend the exemption to a trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1) of the Act. For additional information on new paragraph (*a*.1) of the definition "trust", see the commentary on that provision. This amendment applies to the 1999 and subsequent taxation years.

## Clause 56

### Non-Resident Moving Debt from Canadian Business

ITA
76.1

New section 76.1 of the Act sets out rules that apply where a debt obligation denominated in a foreign currency, of a non-resident taxpayer that carries on business in Canada, either ceases to be or becomes an obligation in respect of the business. These rules ensure that income, gains and losses due to currency fluctuations are appropriately measured.

New subsection 76.1(1) applies any time a foreign-currency debt obligation ceases to be an obligation of a non-resident's Canadian business (otherwise than because the non-resident ceased to be indebted under the obligation). The subsection treats the non-resident, for the purposes of determining any income, loss, capital gain or capital loss due to foreign exchange fluctuation, as having settled the debt immediately before that time for its principal amount. This ensures that any foreign currency gain or loss that accrued during the time the debt was associated with the Canadian business is captured when the debt is transferred out of the Canadian business.

Similarly, new subsection 76.1(2) applies where a non-resident taxpayer's Canadian business acquires a foreign-currency debt obligation that the non-resident formerly held outside the business. This subsection provides that the amount to be used for the purposes of calculating any income, loss, capital gain or capital loss with respect to the debt because of foreign exchange fluctuations is the amount of the debt obligation in Canadian dollars at the time the debt became an obligation of the Canadian business. This ensures that only currency fluctuations from the time the debt was assumed by the Canadian business are subsequently taken into account.

New section 76.1 applies after June 27, 1999 in respect of an authorized foreign bank, and after August 8, 2000 in any other case.

## Clause 57

### Seizure of Property by Creditor

ITA
79.1(2) and (2.1)

Section 79.1 of the Act provides the income tax consequences for creditors in connection with acquisitions and reacquisitions of property from debtors. The operative rules in section 79.1 apply only where property is seized by a creditor in respect of a debt. Under subsection 79.1(2), property is seized by a creditor in respect of a debt where the beneficial ownership of the property is acquired or reacquired by the creditor and the acquisition or reacquisition was in consequence of another person's failure to pay to the creditor all or part of the debt.

Subsection 79.1(2) is amended so that it is subject to new subsection 79.1(2.1). Subsection 79.1(2) provides that, for the purpose of section 79.1, foreign resource property is deemed not to be seized from a non-resident individual or corporation or from a partnership (other than a partnership each member of which is resident in Canada).

These amendments apply in respect of property acquired or reacquired after February 27, 2000.

## Clause 58

### Debt Forgiveness Rules

ITA
80

Section 80 of the Act sets out rules that deal with the forgiveness of commercial debt obligations.

## Definitions

ITA
80(1)

"successor pool"

See the commentary on the amendments to subsection 80(8) of the Act.

## Application of Forgiven Debt Rules

ITA
80(2)(*d*)

Paragraph 80(2)(*d*) of the Act defines the "applicable fraction" of an unapplied portion of a forgiven amount in respect of an obligation issued by a debtor in respect of a loss for a taxation year for the purposes of section 80 of the Act.

Paragraph 80(2)(*d*) is amended to provide that the applicable fraction of the unapplied portion of a forgiven amount in respect of an obligation issued by a debtor in respect of a loss for any taxation year is the fraction required to be used by the taxpayer under amended section 38 for that year. The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

This amendment applies to taxation years that end after February 27, 2000.

## Reduction of Resource Expenditures

ITA
80(8)

The expression "forgiven amount" is defined in subsection 80(1) of the Act. A forgiven amount is applied as required by subsections 80(3) to (7) to reduce various tax attributes of the taxpayer. Under subsection 80(8), the unapplied portion of a debtor's forgiven amount remaining after the application of subsections 80(3) to (7) may, to the extent designated by the debtor in a prescribed form filed with the debtor's income tax return, be applied to reduce specified resource expenditure pools.

Paragraph 80(8)(*a*) is amended so that the resource expenditure pools referred to include "successor" foreign resource expenses, as determined under new subsection 66.7(2.3). The definition "successor pool" in subsection 80(1) is similarly amended.

Paragraph 80(8)(*f*) is introduced to permit the forgiven amount to be applied against a debtor's cumulative foreign resource expense in respect of a country, as determined under new section 66.21.

These amendments apply to taxation years that begin after 2000.

## Capital Gain Where Current Year Capital Loss

ITA
80(12)(*a*)(ii)(B)

Subsection 80(12) of the Act treats the unapplied portion of a forgiven amount in respect of a commercial obligation of a debtor settled in a year as a capital gain of the debtor for the year from the disposition of capital property to the extent of the lesser of the amount of the remaining unapplied portion and the amount of the debtor's net capital losses for the year. In calculating the amount of the net capital losses of the debtor for the year, clause 80(12)(*a*)(ii)(B) includes 4/3 of certain deductible net capital losses of a subsidiary of the debtor that has been wound up into the debtor.

Clause 80(12)(*a*)(ii)(B) is amended to replace the expression "4/3 of" with the word "twice". The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

This amendment applies to taxation years that end after February 27, 2000 except that, for a debtor's taxation year that includes either February 28, 2000 or October 17, 2000, the reference to the word "twice" in clause 80(12)(*a*)(ii)(B) is to be read as a reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the debtor for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

### Income Inclusion

ITA
80(13)

Subsection 80(13) of the Act includes an amount in computing the income of a debtor for the taxation year in respect of the remaining unapplied portion of the forgiven amount in respect of a commercial obligation settled in the year.

The descriptions of D and E (in subparagraph (*a*)(ii) of the description of D in subsection 80(13) and paragraph (*b*) in the description of E in that subsection) are amended to replace references to the fraction "4/3" and the decimal "0.75" with a reference to the word "twice" and the fraction "1/2", respectively. The amendments are consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

These amendments apply to taxation years that end after February 27, 2000 except that, for a debtor's taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the references to "twice" in the description of D in subsection 80(13) is to be read as a reference to the expression "the fraction in paragraph 38(*a*) of the Act that applies to the debtor for the year, multiplied by". The reference to "1/2" in the description of E in subsection 80(13) is to be read as a reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the debtor for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Clause 59

### Debt Forgiveness – Subsequent Payments in Satisfaction of Debt

ITA
80.01(10)

Subsection 80.01(10) of the Act permits, in certain circumstances, a debtor to deduct an amount in computing income in respect of a payment made in respect of the principal amount of a commercial debt obligation that was previously settled.

The amendment to subsection 80.01(10) replaces the reference to the decimal "0.75" with a reference to the fraction "1/2". The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

This amendment applies to taxation years that end after February 27, 2000 except that, for a debtor's taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to "1/2" in subsection 80.01(10) is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the debtor for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Clause 60

### Amounts not Included in Income

ITA
81

Section 81 of the Act lists various amounts which are not included in computing a taxpayer's income.

### Relief for Increased Heating Expenses

ITA
81(1)(*g*.4)

New paragraph 81(1)(*g*.4) of the Act excludes from income amounts received pursuant to the *Order Authorizing Ex Gratia Payments for Increased Heating Expenses*. These amounts represent single payments made to individuals and families who are eligible for the goods and services tax (GST) credit for January 2001.

This amendment applies to amounts received after 2000.

## Travel Expenses

ITA
81(3.1)

Subsection 81(3.1) of the Act excludes from income certain amounts received by a part-time employee in respect of travel expenses. In order to benefit from the exemption, the part-time employee is required to carry on a business or to have another employment. Since one of the purposes of this exemption is to facilitate the recruiting of part-time teachers by universities and other educational institutions located outside the major metropolitan areas, the amendment waives this particular requirement for individuals who are employed as professors or teachers by designated educational institutions. The term "designated educational institution", which is also used for the purposes of the tuition fee and education tax credits, is defined in subsection 118.6(1).

This amendment applies to the 1995 and subsequent taxation years.

## Payments for Volunteer Services

ITA
81(4)

New subsection 81(4) of the Act provides for an exemption equivalent to the deduction available under paragraph 8(1)(*a*), which is being repealed. The exemption applies to the first $1,000 of amounts received by an individual from a government, municipality or public authority for the performance, as a volunteer, of the individual's duties as an ambulance technician, a firefighter or a person who assists in the search or rescue of individuals or in other emergency situations. The exemption is granted under the same conditions as was the deduction under paragraph 8(1)(*a*).

This amendment applies to the 1998 and subsequent taxation years.

## Clause 61

### Rule for Paragraph 84.1(2)(*a*.1)

ITA
84.1(2.1)

Subsection 84.1(2.1) of the Act provides a special rule that applies for the purpose of subparagraph 84.1(2)(*a*.1)(ii). Paragraph 84.1(2)(*a*.1) provides a rule for the purpose of determining the adjusted cost base to a taxpayer of a share for the purposes of section 84.1.

Subsection 84.1(2.1) is amended by replacing the references to the expressions "4/3 of" with references to the word "twice" and by replacing the reference to the fraction "3/4" with a reference to the fraction "1/2". The amendments are consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendments apply to taxation years that end after February 27, 2000 except that, for a taxpayer's taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" in subsection 84.1(2.1) is to be read as a reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the taxpayer for the year, multiplied by" and the reference to the fraction "1/2" is to be read as a reference to the fraction in amended paragraph 38(*a*) that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses rate for the year.

## Clause 62

### Transfer of Property to Corporation by Shareholder

ITA
85

Section 85 of the Act provides for tax-deferred transfers of certain types of properties by a taxpayer to a taxable Canadian corporation in exchange for shares.

ITA
85(1)(*d*.1)

Subsection 85(1) of the Act provides a tax deferral for the transfer of various types of property by a taxpayer to a taxable Canadian corporation for consideration that includes shares of the corporation's capital stock. Paragraph 85(1)(*d*.1) provides specific rules to ensure that the tax accounts relating to eligible capital property in respect of a business are carried through from the transferor to the transferee. Descriptions D and E in paragraph 85(1)(*d*.1) are amended consequential to the re-numbering of subsection 14(1) of the Act, which is described in further detail in the commentary to that subsection.

These amendments apply to taxation years that end after February 27, 2000.

ITA
85(1.11)

Subsection 85(1.1) describes the types of property (referred to in the Act as "eligible property") that may be transferred to a corporation under subsection 85(1).

New subsection 85(1.11) provides that a foreign resource property (or an interest in a partnership that derives all or part of its value from one or more foreign resource properties) is not an "eligible property" of a taxpayer in respect of a transfer to a corporation where:

- the taxpayer and the corporation do not deal with each other at arm's length; and

- it is reasonable to conclude that one of the purposes of the disposition, or a series of transactions or events of which the disposition is a part, is to increase the extent to which any person may claim a deduction under section 126. (An increase of a deduction under section 126 could arise as a consequence of a reduction of an amount that the person deducts, or is entitled to deduct, under any combination of subsections 66(4), 66.21(4) and 66.7(2) and (2.3).)

This provision is intended to counter the avoidance of income-based limits on the foreign tax credit in section 126 that might be achieved through the sale of direct or indirect interests in foreign resource property at less than fair market value. In general terms, under subsection 126(2) the level of a foreign tax credit for a taxpayer in respect of a business carried on in a foreign country cannot exceed a specified percentage of the taxpayer's Canadian income tax. The specified percentage is essentially the percentage that the taxpayer's "qualifying income" from that business is of the taxpayer's world-wide income. (New subsection 126(9) reinforces the "qualifying income" limit for foreign tax credits by generally requiring a taxpayer to maximize foreign exploration and development expense deductions and foreign resource deductions for the purpose of computing qualifying income.)

This amendment applies to transfers that occur after December 21, 2000

## Clause 63

### Share-for-Share Exchange

ITA
85.1

Section 85.1 of the Act permits a tax-deferred rollover for shareholders who exchange shares of a taxable Canadian corporation for shares of a Canadian purchaser corporation in the course of an arm's length sale of the acquired corporation's shares. Subsection 85.1(1) provides, amongst other things, that the shareholder's tax cost of the old shares becomes the tax cost of the new shares with the result that any capital gain is deferred. If, however, the shareholder recognizes, in the shareholder's tax return for the year in which the exchange occurred, any portion of the gain or loss realized on the share exchange, subsection 85.1(1) provides that the rollover will not apply to the shares. Subsection 85.1(2) of the Act sets out other circumstances where the rollover will not be available. These include circumstances where the purchaser corporation and the shareholder are not dealing at arm's length immediately before the exchange or where the shareholder controls the purchaser immediately after the exchange.

Subsection 85.1(2) of the Act is amended to add new paragraph (*e*), consequential to the introduction of new subsection 85.1(5). New paragraph 85.1(2)(*e*) provides that subsection 85.1(1) will not apply to allow a tax-deferred rollover in respect of a Canadian share-for-share exchange where a vendor is a foreign affiliate and the vendor includes any portion of the gain or loss realized from the exchange in computing its foreign accrual property income for the year.

New subsection 85.1(5) of the Act provides a similar tax-deferred rollover for shareholders who exchange shares of a foreign corporation for shares of another foreign corporation to that provided in subsection 85.1(1) in respect of exchanges of shares of Canadian corporations. The application of subsection 85.1(5) is subject to the rollover for foreign shares contained in subsection 85.1(3) and 95(2) of the Act.

New subsection 85.1(6) of the Act describes the circumstances where new subsection 85.1(5) will not apply to a foreign share-for-share exchange. The rules in subsection 85.1(6) are similar to those in subsection 85.1(2), except that paragraph 85.1(6)(*e*) provides that subsection 85.1(5) will not apply where the vendor is a foreign affiliate and the exchanged foreign shares are excluded property (within the meaning assigned by subsection 95(1) of the Act) of the vendor. In other words, excluded property is not eligible for the foreign share-for-foreign share rollover in new subsection 85.1(5).

New subsections 85.1(2), (5) and (6) apply to foreign share-for-share exchanges that occur after 1995. Taxpayers may request a reassessment of their 1996, 1997 and 1998 taxation years in cases where they have disposed of shares in the relevant year in circumstances in which subsections 85.1(5) and (6) of the Act may apply to the disposition. These requests should be made in writing to the Canada Customs and Revenue Agency Tax Centre which serves the area in which the taxpayer lives.

## Clause 64

### Foreign Spin-Offs

ITA
86.1

New section 86.1 of the Act allows for a tax deferral, generally on an elective basis, in respect of certain foreign distributions of spin-off shares by a foreign corporation that are received by Canadian resident shareholders of the foreign corporation. The rules in new section 86.1 are described below and may be applied to otherwise taxable distributions received after 1997.

### Eligible Distribution Not Included in Income

ITA
86.1(1) and (2)

New subsection 86.1(1) of the Act provides that an amount in respect of an "eligible distribution" of spin-off shares received by a taxpayer is not to be included in computing the taxpayer's income. Further, the cost of those shares to the taxpayer is not their fair market value as otherwise provided by subsection 52(2) of the Act. Rather, the cost of the original share which generated the distribution of the spin-off share will be allocated amongst the two.

New subsection 86.1(2) defines an "eligible distribution". A distribution of spin-off shares to a taxpayer is an "eligible distribution" only if a number of conditions are met.

First, the distribution to the taxpayer must be because the taxpayer owns common shares in the distributing corporation (i.e., the "original shares").

Second, the distribution to the taxpayer must consist solely of common shares of the capital stock of another corporation owned by the distributing corporation (i.e., the "spin-off shares") – the distribution to the taxpayer must not include non-share consideration.

Third, in the case of a distribution made by a corporation in the United States,

- both the distributing corporation and the spun-off corporation (the issued shares of which are being spun-off) must be resident of the United States at the time of the distribution and must never have been resident in Canada,

- the taxpayer's original shares must be included in a class of stock that is widely held and actively traded on a prescribed stock exchange (section 3201 of the *Income Tax Regulations*) in the United States at the time of the distribution, and

- the shareholders of the distributing corporation that are resident in the United States must not be taxable in respect of the distribution under the United States Internal Revenue Code.

Fourth, in the case of a distribution that is not in the United States and that is prescribed by regulation,

- both the distributing corporation and the spun-off corporation (the issued shares of which are being spun-off) must be resident of the same foreign country, other than the United States, with which Canada has a tax treaty and those corporations must never have been resident in Canada,

- the taxpayer's original shares must be included in a class of stock that is widely held and actively traded on a prescribed stock exchange (section 3201 of the *Income Tax Regulations*) at the time of the distribution,

- under the law of the country in which the distributing corporation is resident, the shareholders of the distributing corporation must not be taxable in respect of the distribution, and

- such terms and conditions as are considered appropriate in the circumstances with respect to the prescription must be met.

Fifth, the distributing corporation must provide the Minister of National Revenue, within six months of the distribution, evidence satisfactory to the Minister of certain matters including the type and fair market value of each property distributed to residents of Canada and the name and address of each resident of Canada that received property because of the distribution. Property that is distributed to residents of Canada includes, for example, property that is distributed to investment dealers resident in Canada as well as individual and corporate shareholders.

Sixth, generally the taxpayer acquiring the spin-off shares must elect in writing (filed with the taxpayer's return of income for the year in which the distribution occurs) to have section 86.1 apply to the distribution and provide evidence satisfactory to the Minister of National Revenue of certain matters relating to the distribution and the taxpayer.

The information submitted to the Minister must establish, for example, the number, cost amount and fair market value of the taxpayer's original shares immediately before the distribution, and the number, and the fair market value, of the taxpayer's original shares and the spin-off shares immediately after the distribution. Furthermore, in the case of a distribution received before October 18, 2000, while the election must be filed in writing with the Minister, it need not be included in the taxpayer's return of income for the year in which the distribution occurs.

Information filed by the corporation or the taxpayer under paragraph 86.1(2)(*e*) or (*f*) in respect of a distribution that occurred before these provisions receive Royal Assent will be considered to have been filed on time if it is filed within 90 days of that Royal Assent.

However, if the taxpayer acquiring the spin-off shares is a taxpayer to which Part XI of the Act applies, no election is required and the cost adjustment rules will apply automatically where the conditions of subsections 86.1(2) and (3) are satisfied. Part XI provides that certain deferred income trusts, pension trusts and corporations, registered investments and persons exempt from Part I tax (e.g., an employees profit sharing plan) will generally be subject to a special tax on foreign property or certain rights to acquire shares. For more detail on the foreign property rule, see the commentary on Part XI.

A trust or corporation referred to in Part L of the *Income Tax Regulations* may be subject to foreign property limits under that Part of the Regulations. However, because Part XI of the Act does not apply in respect of such a trust or corporation (i.e., the trust or corporation would not be expected to be a registered investment), the trust or corporation must meet all of the requirements of section 86.1, including the requirement to file an election, in order for that section to apply for the purposes of Part I of the Act and Part L of the Regulations.

**Cost Adjustments**

ITA
86.1(3)

New subsection 86.1(3) of the Act provides two rules that adjust the cost amount of a taxpayer's original shares, and spin-off shares received on an eligible distribution.

New paragraph 86.1(3)(*a*) provides a formula for computing the amount that is to be deducted from the cost amount of a taxpayer's original share. The amount to be deducted from the cost amount of each original share is determined by the formula:

$$A \times (B/C)$$

where

A is the cost amount to the taxpayer of the original share immediately before the distribution (determined without reference to section 86.1),

B is the fair market value of the spin-off share immediately after its distribution to the taxpayer,

C is the total of

- the fair market value of the original share immediately after the distribution of the spin-off share to the taxpayer, and
- the fair market value of spin-off share immediately after its distribution to the taxpayer.

New paragraph 86.1(3)(*b*) provides that the cost of a taxpayer's spin-off share is equal to the amount deducted from the cost amount of the taxpayer's original share.

***Example:***

*Assume:*

*John owns one original common share of DC Ltd. (resident in the U.S.), which distributes one spin-off share of SO Ltd. (also resident in the U.S.) on a per share basis to holders of common shares of DC Ltd. The cost amount of John's original share of DC Ltd. is $10 immediately before the distribution and its fair market value immediately after the distribution is $70. The fair market value of the SO Ltd. spin-off share is $30 immediately after the distribution.*

*Application of subsection 86.1(3):*

- *The cost amount of John's original share in DC Ltd. is reduced to $7 – i.e., the $10 cost amount less the $3 amount deducted because of paragraph 86.1(3)(a).*
  - *$10 – (A x (B/C))*

    A = *$10.*
    B = *$30.*
    C = *$100 (= $70 + $30).*
- *The cost of John's spin-off share in SO Ltd. is $3 because of paragraph 86.1(3)(b).*

The adjustments in subsection 86.1(3) to the cost amount of an original share and spin-off share apply for all purposes of the Act, including the foreign property rule contained in Part XI of the Act. The application for purposes of the foreign property rule in Part XI of the Act will ensure that the level of foreign property held by a taxpayer subject to that rule is not affected solely because of an eligible distribution.

### Inventory

ITA
86.1(4)

New subsection 86.1(4) provides rules that apply for the purpose of calculating the value of property (an original share and a spin-off share) described in an inventory of a taxpayer's business. New paragraph 86.1(4)(*a*) provides that a spin-off share that is included in such an inventory is deemed not to be an acquisition of property in the fiscal period of the business in which the distribution occurs. This rule is intended to exclude the cost of the spin-off share from the cost of inventory acquired the year, as the cost of the spin-off shares will normally be reflected in the cost of the original share.

New paragraph 86.1(4)(*b*) provides that, for greater certainty, the value of the spin-off share is to be included in computing the value of that inventory at the end of the fiscal period.

### Reassessments

ITA
86.1(5)

New subsection 86.1(5) allows the Minister of National Revenue to make such reassessments, determinations and redeterminations as are necessary where information is obtained that the conditions in subparagraph 86.1(2)(*c*)(iii) or (2)(*d*)(iii) are not, or are no longer, satisfied. Those conditions are more fully described in the commentary to new subsection 86.1(2).

## Clause 65

### Amalgamation

ITA
87

Section 87 of the Act sets out rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation.

## New Corporation Continuation of a Predecessor

ITA
87(1.2)

Section 87 of the Act sets out rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation.

Where there has been an amalgamation of two or more corporations, the successor rules in section 66.7 generally provide that unclaimed resource expenditures of a predecessor corporation may be deducted by the new corporation only within the limitations of the successor rules (i.e., against "streamed income" related to the predecessor corporation's resource properties). However, under subsection 87(1.2) the successor rules do not apply where there has been an amalgamation of a corporation and one or more of its subsidiary wholly-owned corporations (as defined by subsection 87(1.4)) or an amalgamation of two or more corporations which are subsidiary wholly-owned corporations of the same corporation.

Subsection 87(1.2) is amended so that the same exception applies in respect of foreign resource expenses calculated under new section 66.21.

This amendment applies to amalgamations that occur after 2000.

## Shares of Foreign Affiliate

ITA
87(2)(*u*)

Paragraph 87(2)(*u*) of the Act applies where two or more taxable Canadian corporations (referred to as "predecessor corporations") amalgamate to form a new corporation. Subparagraph 87(2)(*u*)(ii) provides that any dividend received by a predecessor corporation on a share that is an exempt dividend is considered for the purposes of subsection 93(2) to be an exempt dividend received by the new corporation. Subparagraph 87(2)(*u*)(ii) of the Act is amended to refer to subsections 93(2) to (2.3), effective after November 1999, to refer to new subsections 93(2) to (2.3) which limit the losses arising on the disposition of shares of a foreign affiliate.

## Foreign Mergers

ITA
87(8) and (8.1)

Subsections 87(8) and (8.1) of the Act provide tax-deferred rollover treatment to a shareholder of a foreign corporation (a predecessor) in respect of a disposition of shares of the predecessor where the predecessor undergoes a merger with one or more other foreign corporations. It also provides a shareholder with a similar rollover in respect of the disposition of shares of the predecessor in the case of a three-way or "triangular" foreign merger. The rollover is only available where the predecessor corporations, the new corporation formed on the merger and, in the case of a triangular merger, the corporation that controls the new corporation formed on the merger, are resident in the same foreign jurisdiction.

Subsections 87(8) and (8.1) are amended to remove the requirement that all of the corporations be resident in the same foreign jurisdiction. Consequently, the tax-deferred rollover will be available under subsection 87(8) in cases where the foreign corporations are resident in the same or different foreign jurisdictions.

New subsections 87(8) and (8.1) apply to mergers that occur after 1995. Where subsection 87(8) would otherwise apply to a taxpayer in respect of a merger that occurred in 1996, 1997 or 1998, the taxpayer can notify the Minister of National Revenue in writing, before the taxpayer's filing-due date for the taxation year in which subsections 87(8) and (8.1) receive Royal Assent, that the taxpayer elects not to have the subsection apply. Where the taxpayer so elects, the election will be considered to have been made in accordance with new subsection 87(8) of the Act.

## Share Deemed Listed

ITA
87(10)

Subsection 87(10) of the Act treats certain shares issued as part of an "amalgamation squeeze-out" as being listed on a prescribed stock exchange. The subsection is amended, with application after October 1, 1996, to replace its reference to subsection 115(1) of the

Act with a reference to the new definition "taxable Canadian property" in subsection 248(1) of the Act. This consequential change is not intended to have any substantive effect on the operation of subsection 87(10).

## Clause 66

### Winding-up of a Corporation

ITA
88(1)

Section 88 of the Act deals with the tax consequences arising from the winding-up of a corporation. Subsection 88(1) provides rules that apply where a subsidiary has been wound up into its parent corporation where both corporations are taxable Canadian corporations and the parent owns at least 90% of the issued shares of each class of the subsidiary's capital stock.

ITA
88(1)(*c*)(vi)(B)(III)

Paragraph 88(1)(*c*) of the Act provides that the cost to a parent corporation of each property distributed to it on the winding-up of a subsidiary is equal to the subsidiary's proceeds of disposition of the property plus, where the property is not an "ineligible property", an amount determined under paragraph 88(1)(*d*) of the Act in respect of the property. An ineligible property is defined in paragraph 88(1)(*c*) and consists of four types of property. Subparagraph 88(1)(*c*)(vi) describes the fourth type of ineligible property.

Subclause 88(1)(*c*)(vi)(B)(III) of the Act provides that property will be an ineligible property for the purposes of paragraph 88(1)(*c*) where the property distributed to the parent on the winding-up is acquired as part of the series of transactions or events that includes the winding-up by a person described in subclause 88(1)(*c*)(vi)(B)(III).

A person described in subclause 88(1)(*c*)(vi)(B)(III) of the Act is

A. a corporation (other than a specified person) of which any person who was a specified shareholder of the subsidiary is a specified shareholder, or

B. a corporation (other than a specified person) in which persons described in subclause 88(1)(*c*)(vi)(B)(II) owns shares that, if owned by one person, would have made that person a specified shareholder of the corporation.

Subclause 88(1)(*c*)(vi)(B)(III) of the Act is amended to also exclude from persons described therein the subsidiary itself. This amendment will ensure that where a target/subsidiary corporation transfers some of its property to a subsidiary of the target prior to the parent's acquisition of control of the target, the transfer, in and by itself, will not cause property distributed to the parent on the winding-up of the target/subsidiary to be ineligible property.

Amended subclause 88(1)(*c*)(vi)(B)(III) applies to windings-up that begin after November 1994.

ITA
88(1)(*c*.2)(iii)(A)

Subparagraph 88(1)(*c*.2)(iii) of the Act provides, for the purposes of paragraph 88(1)(c.2) and subparagraph 88(1)(*c*)(vi) of the Act, that an expanded definition of "specified shareholder" in subsection 248(1) of the Act is to be used. In particular, clause 88(1)(*c*.2)(iii)(A) provides that the definition of specified shareholder is to be read as including a reference to "or of any other corporation that is related to the corporation and that has a significant direct or indirect interest in any issued shares of any class of the capital stock of the corporation" rather than the reference to "or of any corporation that is related to the corporation".

Amended clause 88(1)(*c*.2)(iii)(A) provides for a new modification to the expanded definition "specified shareholder" in subsection 248(1) of the Act. In particular, for the purposes of paragraph 88(1)(*c*.2) and subparagraph 88(1)(*c*)(vi), the definition of specified shareholder is to be read as including a reference to "the issued shares of any class (other than a specified class) of the capital stock of the corporation or of any other corporation that is related to the corporation and that has a significant direct or indirect interest in any issued shares of any class of the capital stock of the corporation" rather than the reference to "or of any corporation that is related to the corporation". Proposed clause 88(1)(*c*.2)(iii)(A) ensures that in determining whether a person is a specified shareholder of a particular corporation, for the purposes of paragraph 88(1)(*c*.2) and subparagraph 88(1)(*c*)(vi), the person does not have to account for shares of a specified class. Specified class is a new expression and is defined in new paragraph 88(1)(*c*.8) of the Act.

Amended clause 88(1)(*c*.2)(iii)(A) applies to windings-up that begin after November 1994.

ITA
88(1)(*c*.8)

New paragraph 88(1)(*c*.8) of the Act is relevant in determining whether a person is a specified shareholder for the purposes of a divisive reorganization commonly known as a "backdoor butterfly" described in subparagraph 88(1)(*c*)(vi) of the Act. (See the commentary on subclause 88(1)(*c*)(vi)(B)(III) of the Act regarding the significance of specified shareholder status.) Shares of a specified class are considered to be financing or debt-like shares and consequently need not be counted in determining whether a person is a specified shareholder of a corporation.

New paragraph 88(1)(*c*.8) provides that shares of the capital stock of a corporation will qualify as shares of a specified class where

1) the paid-up capital in respect of the class was not at any time less than the fair market value of the consideration for which the shares of that class then outstanding were issued;

2) the shares are non-voting in respect of the election of the Board of Directors of the corporation, except in the event of a failure or default under the terms or conditions of the shares;

3) the shares are not convertible into or exchangeable for any other shares (other than shares of a specified class) of the capital stock of the corporation; and

4) the holder of the share is not entitled to receive on the redemption, cancellation or acquisition of the share by the

corporation or any person who does not deal at arm's length with the corporation, an amount (excluding any premium for early redemption) greater than the fair market value of the consideration for which the share was issued plus the amount of any unpaid dividends on the share.

New paragraph 88(1)(*c*.8) applies to windings-up that begin after November 1994.

ITA
88(1.5)

Section 88 of the Act deals with the tax consequences arising from the winding-up of a corporation. Where there has been a winding-up of a subsidiary into a parent corporation that owned at least 90% of the subsidiary's shares, subsection 88(1.5) provides that the parent is considered to be the same corporation as the subsidiary for the purpose of the provisions dealing with the deduction of exploration, development and resource property expenses. This effectively removes the restrictions of the successor corporation rules that would otherwise apply with respect to the deduction by the parent of the unclaimed resource expenses of the subsidiary following its winding-up.

Subsection 88(1.5) is amended so that the same rule also applies in respect of foreign resource expenses calculated under new section 66.21.

This amendment applies to windings-up that occur after 2000.

## Amalgamation Deemed not to be an Acquisition of Control

ITA
88(4)

Subsection 88(4) of the Act sets out for the purposes of paragraphs 88(1)(*c*), (*d*) and (*d*.2) the circumstances in which, among other things, a corporation formed on an amalgamation will be considered to be a continuation of its predecessor corporations. Subsection 88(4) is amended to also apply for the purpose of paragraph 88(1)(*c*.2), and for greater certainty, subsection 88(4) is amended to clarify that it also applies for the purposes of paragraphs 88(1)(*c*.3) to (*c*.8) and (*d*.3) of the Act.

These amendments apply to windings-up that begin after November 1994.

## Clause 67

### Definitions – Capital Dividend Account

ITA
89(1)

"capital dividend account"

Subsection 89(1) defines certain terms that apply to corporations and their shareholders.

Where the appropriate elections have been made by a private corporation, dividends paid out of its capital dividend account are received tax-free by the corporation's shareholders who are resident in Canada. A corporation's capital dividend account includes the untaxed portion of gains in respect of dispositions of capital property.

Clause (*a*)(i)(A) of the definition "capital dividend account" is amended to add a bracket that was omitted when the provision was amended by S.C. 1998, c. 19, ss. 17(1) [formerly Bill C-28].

The current amendment applies to dispositions made after December 8, 1997, other than a disposition made under a written agreement made before December 9, 1997 – the same coming-into-force provision as the 1998 amendment.

Paragraph (*c*) of the definition "capital dividend account" describes the "untaxed portion" of gains in respect of eligible capital property. Because, under existing paragraph 14(1)(*b*) of the Act, a corporation's gain in respect of eligible capital property was previously aggregated with a recapture of the paragraph 20(1)(*b*) deductions that were previously claimed, paragraph (*c*) of the definition "capital dividend account" describes the untaxed portion of gains in respect of eligible capital property by reference to the corporation's cumulative eligible capital, eligible capital expenditures and variable E in the definition "cumulative eligible capital".

Amended paragraph 14(1)(*b*) identifies the taxable (2/3 for taxation years that end after February 27, 2000 and before October 18, 2000 and 1/2 for taxation years that end after October 17, 2000) portion of gains in respect of eligible capital property. Accordingly it is possible to simplify the description of the untaxed (1/3) portion of gains in respect of eligible capital property for taxation years that end after February 27, 2000 and before October 18, 2000 and (1/2) portion for taxation years that end after October 17, 2000. Paragraph (*c*) of the definition "capital dividend account" is therefore amended to describe amounts determined under that provision as it applied to taxation years that ended before February 28, 2000.

New paragraph (*c*.1) of the definition "capital dividend account" generally requires the inclusion in the capital dividend account of 1/2 of all amounts required by amended paragraph 14(1)(*b*) of the Act to be included in the corporation's income for taxation years that end after February 27, 2000 and before October 18, 2000.

New paragraph (*c*.2) of the definition requires the inclusion of the amount required by paragraph 14(1)(*b*) of the Act (as amended) to be included for taxation years that end after October 17, 2000.

Both these amounts are reduced to take into account the appropriate portion of bad debts in respect of dispositions of eligible capital property. The calculation of the reduction for bad debts is complicated by the interaction of different inclusion rates for capital gains that may be relevant during the period. New paragraphs (*c*.1) and (*c*.2) of the definition "capital dividend account" recognize both the deduction under subsection 20(4.2) and the deemed allowable capital loss under subsection 20(4.3) as amounts that reduce the capital dividend account. For further detail, see the commentary on subsections 20(4.2) and (4.3) of the Act.

These amendments apply in respect of taxation years that end after February 27, 2000.

New paragraph (*f*) of the definition "capital dividend account" provides for the inclusion in a corporation's capital dividend account of an amount in respect of the non-taxable portion of capital gains distributed by a trust to the corporation. The amount permitted to be included is equal to the lesser of two amounts.

The first of the two amounts is the amount by which the distribution exceeds the amount designated under subsection 104(21) by the trust (other than a designation to which subsection 104(21.4) of the Act applies) in respect of the corporation in respect of those capital gains. The exclusion from the first amount of a designated amount to which subsection 104(21.4) applies, prevents a double addition to the corporation's capital dividend account. This is because subsection 104(21.4) already deems certain capital gains of a trust to be those of the beneficiary. (For more detail on subsection 104(21.4), see the commentary on that provision.)

The second of the two amounts represents the amount of the non-taxable portion of a capital gain of a trust associated with the net taxable capital gains of the trust designated by the trust in respect of the corporation. This amount is determined by the formula "A x B", where "A" is the fraction or whole number determined when 1 is subtracted from the reciprocal of the fraction under paragraph 38(*a*) applicable to the trust for the year, and "B" is the designated amount described above. Consider, for example, a trust with realized capital gains of $100, a capital gains inclusion rate of 3/4 and net taxable capital gains of $60. If the trust designates $60 under subsection 104(21) in respect of the corporation and pays $80 (as opposed to the full $100) to the corporation in respect of the trust's capital gains, the corporation may add $20 to its capital dividend account (i.e., the lesser of ($80 - $60) and (4/3 - 1 x $60)).

New paragraph (*g*) of the definition "capital dividend account" provides for the inclusion of an amount in a corporation's capital dividend account in respect of particular capital dividends received by a trust and distributed by the trust to the corporation equal to the lesser of the amount of the distribution and the amount designated under subsection 104(20) of the Act by the trust in respect of the corporation in respect of the particular dividend.

Paragraphs (*f*) and (*g*) of the definition "capital dividend account" apply to elections in respect of capital dividends that became payable after 1997.

## Clause 68

### Amounts to be Included in Respect of Share of a Foreign Affiliate

ITA
91

Section 91 of the Act sets out rules for determining amounts that a taxpayer resident in Canada is to include in computing its income for a particular year as income from a share of a controlled foreign affiliate of the taxpayer.

### Where Share Acquired by a Partnership

ITA
91(7)

New subsection 91(7) of the Act applies where a taxpayer that is a taxable Canadian corporation acquires a share of the capital stock of a corporation that is, immediately after the acquisition, a foreign affiliate of the taxpayer, from a partnership of which the taxpayer or a corporation resident in Canada with which the taxpayer was not dealing at arm's length at the time the share was acquired was a member (the "member"). Where, after the acquisition, the taxpayer receives a dividend on such a share out of the foreign affiliate's taxable surplus, subsection 91(7) allows the taxpayer to make a deduction under subsection 91(5) of the Act in respect of the net foreign accrual property income in respect of the share that was previously included in the income of the member from the partnership from which the taxpayer acquired the share. Subsection 91(7) allows the deduction under subsection 91(5) by deeming the taxpayer's adjusted cost base of the share to have been adjusted under subsection 92(1) of the Act by the member's share of any additions to, or deductions from, the adjusted cost base of the share to the partnership under subsection 92(1).

New paragraph 91(7)(*a*) provides that the member's share of the increase to the partnership's adjusted cost base of the share is the amount included in the member's income under subsection 96(1) in respect of the affiliate's foreign accrual property income included in the partnership's income under subsections 91(1) or (3) of the Act. New paragraph 91(7)(*b*) provides that the member's share of the decrease to the partnership's adjusted cost base of the share is the amount by which the member's share of the partnership's income determined under subsection 96(1) decreased as a result of an amount deducted in computing the partnership's income under subsections 91(2), (4) or (5) of the Act.

New subsection 91(7) applies to shares acquired after November 1999.

## Clause 69

### Adjusted Cost Base of Share of Foreign Affiliate

ITA
92

Section 92 of the Act provides for adjustments to be made to the adjusted cost base of a share in a foreign affiliate with respect to certain amounts included or deducted in computing income of the owner of the share.

### Disposition of a Partnership Interest

ITA
92(4)

New subsection 92(4) of the Act applies where a member of a partnership that is a corporation resident in Canada or a foreign affiliate of a corporation resident in Canada disposes of all or any portion of its interest in the partnership. New subsection 92(4) ensures that prior dividends received by the partnership out of the affiliate's pre-acquisition surplus, to the extent that they exceed related foreign withholding taxes, are included in calculating the member's proceeds of disposition on the partnership interest. Subsection 92(4) increases the member's proceeds of disposition by the amount that was deductible (or would have been deductible if it were a corporation resident in Canada) by the member under paragraph 113(1)(*d*) of the Act net of foreign withholding taxes. The amount added to the member's proceeds does not include amounts previously added under this subsection, or amounts that were previously deemed to be a gain under new subsection 92(5) of the

Act. Where the member does not dispose of all of its interests in the partnership, the deemed proceeds under new subsection 92(4) are reduced in proportion to the interests that were retained.

New subsection 92(4) applies to dispositions that occur after November 1999.

ITA
92(5) and (6)

### Deemed Gain from the Disposition of a Share

New subsections 92(5) and (6) of the Act apply where a partnership disposes of a share of corporation. Where a corporation resident in Canada or a foreign affiliate of a corporation resident in Canada is a member of the partnership (the "member"), new subsections 92(5) and (6) treat the member as having a gain on the disposition of the share equal to the amount that was deductible (or would have been deductible by the member if it were a corporation resident in Canada) by the member under paragraph 113(1)(*d*) of the Act in respect of dividends (net of foreign withholding taxes) received by the partnership on the share that were paid out of pre-acquisition surplus. The gain in this subsection is reduced by any amount that was added to the member's proceeds of disposition of a partnership interest under subsection 92(4).

New subsections 92(5) and (6) apply to dispositions that occur after November 1999.

## Clause 70

### Disposition of Shares in a Foreign Affiliate

ITA
93

Section 93 of the Act contains a number of rules relating to the disposition of shares of a foreign affiliate of a taxpayer resident in Canada.

## Election re Disposition of Share in Foreign Affiliate

ITA
93(1)

Subsection 93(1) of the Act permits a corporation resident in Canada that disposes of a share of a foreign affiliate of the corporation to treat the proceeds of disposition of the share as a dividend.

In such circumstances, subparagraph 93(1)(*b*)(ii) provides that the foreign affiliate of the corporation will be considered to have redeemed shares of a class of its capital stock for the purposes of calculating certain of its surplus accounts in respect of the corporation. Subparagraph 93(1)(*b*)(ii) is amended to clarify that those accounts take their meaning from those meanings assigned for the purpose of Part LIX of the *Income Tax Regulations*. New subparagraph 93(1)(*b*)(ii) applies to dispositions that occur after November 1999.

## Disposition of a Share of a Foreign Affiliate Held by a Partnership

ITA
93(1.2)

New subsection 93(1.2) of the Act provides that, where a particular corporation resident in Canada or a foreign affiliate of the particular corporation (referred to as "disposing corporation") would, but for this subsection, have a taxable capital gain from a partnership from the disposition by the partnership of shares of a class of the capital stock of a foreign affiliate of the corporation, and the disposing corporation elects in prescribed manner in respect of the gain, the amount designated will reduce the taxable capital gain and will be grossed-up and recharacterized as a dividend received on the share by the disposing corporation.

New paragraph 93(1.2)(*a*) provides that twice the amount designated by the disposing corporation in respect of the shares or, where proposed subsection 93(1.3) applies twice the amount determined under that subsection, will be treated as a dividend received on the shares by the disposing corporation from the foreign affiliate.

The amount designated by the disposing corporation in respect of the shares disposed of cannot exceed that proportion of the taxable capital gain of the partnership from the disposition by the partnership of the shares that the number of shares of that class that the disposing corporation can be considered to have disposed of (the difference between the number of such shares of the foreign affiliate that the disposing corporation was deemed to own for the purpose of subsection 93.1(1) immediately before the disposition and the number of such shares of the foreign affiliate that the disposing corporation was deemed to own for the purposes of subsection 93.1(1) immediately thereafter) is of the number of such shares of the affiliate owned by the partnership, immediately before the disposition.

New paragraph 93(1.2)(*b*) provides that, notwithstanding section 96, the disposing corporation's taxable capital gain from the disposition of the shares is considered to be the amount by which the disposing corporation's taxable capital gain from the disposition of the shares otherwise determined exceeds the amount designated by the particular corporation in respect of the shares.

New paragraph 93(1.2)(*c*) provides that, for the purpose of any regulation made under subsection 93(1.2), the disposing corporation is treated as having disposed of the number of shares of the class of the foreign affiliate which is to be determined as the difference between the number of shares of the foreign affiliate that the disposing corporation was deemed to own for the purpose of subsection 93.1(1) immediately before the disposition and the number of such shares of the foreign affiliate that the disposing corporation was deemed to own for the purposes of subsection 93.1(1) immediately after the disposition.

New paragraph 93(1.2)(*d*) provides that, for the purpose of applying section 113 in respect of the dividend referred to in new paragraph 93(1.2)(*a*), the disposing corporation is considered to have owned the share on which the dividend was received.

New paragraph 93(1.2)(*e*) provides that, where the disposing corporation has a taxable capital gain from the disposition of the share because of the application of subsection 40(3) of the Act to the partnership in respect of the share, the partnership is treated for the purposes of this subsection as having disposed of the share.

This subsection applies to dispositions that occur after November 1999 except that the word "twice" is to be read as "4/3 of" for dispositions that occur after November 1999 and in a taxation year that ends before February 28, 2000. For dispositions in taxation years that include February 28, 2000, October 17, 2000 or begin after February 27, 2000 and end before October 18, 2000, the references to the word "twice" are to be read as references to the reciprocal of the capital gains calculation rate applicable to the corporation resident in Canada or to the foreign affiliate for the taxation year.

### Deemed Election

ITA
93(1.3)

New subsection 93(1.3) of the Act provides that, where a foreign affiliate of a particular corporation resident in Canada has a gain from the disposition by a partnership of a share of a foreign affiliate of the particular corporation and the share is excluded property, the particular corporation will treated as having made the election under new subsection 93(1.2) in respect of the difference between the number shares of the foreign affiliate that the disposing corporation was deemed to own for purposes of subsection 93.1(1) immediately before the disposition and the number of such shares of the foreign affiliate that the disposing corporation was deemed to own for the purposes of subsection 93.1(1) immediately after the disposition.

This subsection applies to dispositions that occur after November 1999.

### Loss Limitation on Disposition of Share

ITA
93(2)

Subsection 93(2) of the Act is an anti-avoidance rule. It reduces a loss arising on a disposition of a share of the capital stock of a foreign affiliate of a corporation resident in Canada by the amount of exempt dividends received on the share before the disposition. The rule applies to the corporation resident in Canada and any foreign affiliate of such a corporation in respect of a share of a foreign affiliate of the corporation resident in Canada.

Subsection 93(2) of the Act is repealed and replaced by new subsections 93(2) to (2.3) of the Act because of the introduction of new section 93.1 of the Act.

Subsection 93(2) of the Act applies where a corporation resident in Canada or a foreign affiliate of such a corporation has a loss from the disposition of a share of a foreign affiliate of the corporation resident in Canada. Where the foreign affiliate has the loss from the disposition of a share of another foreign affiliate of the taxpayer, the rule does not apply where that affiliate share is excluded property of the disposing affiliate.

Where the rule applies, the loss arising on the disposition of the affiliate share is reduced by the exempt dividends received on the share by the particular corporation resident in Canada, a foreign affiliate of the particular corporation, another corporation related to the particular corporation or a foreign affiliate of a corporation resident in Canada that is related to the particular corporation, to the extent that those exempt dividends have not already reduced a capital loss or an allowable capital loss under subsections 93(2) to 93(2.3) arising on other dispositions of property. The term "exempt dividend" is defined in subsection 93(3) of the Act and is modified consequential to the introduction of section 93.1 of the Act.

New subsection 93(2) applies to dispositions that occur after November 1999.

For taxation years that end after February 27, 2000, the reference in new subsection 93(2) to the expression "4/3 of" is generally replaced with a reference to the word "twice".

For a taxation year of a corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" in subsection 93(2) is to be read as reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the taxpayer for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Loss Limitations – Disposition of Share by Partnership

ITA
93(2.1)

New subsection 93(2.1) of the Act applies where a corporation resident in Canada or a foreign affiliate of such a corporation has an allowable capital loss from a partnership arising on the disposition by the partnership of a share of a foreign affiliate of the corporation resident in Canada. Where the foreign affiliate has the allowable capital loss, the rule does not apply where that affiliate share would be excluded property of the disposing affiliate if the affiliate owned the share.

For taxation years that end before February 28, 2000, the allowable capital loss from the partnership arising on the disposition of the affiliate share is reduced by 3/4 of the exempt dividends received on the share by the particular corporation resident in Canada, a foreign affiliate of the particular corporation, another corporation related to the particular corporation or a foreign affiliate of a corporation resident in Canada that was related to the particular corporation, to the extent that those exempt dividends had not already reduced a capital loss or an allowable capital loss under subsections 93(2) to 93(2.3) arising on other dispositions of property. The term "exempt dividend" is defined in subsection 93(3) of the Act and is modified consequential to the introduction of section 93.1 of the Act.

New subsection 93(2.1) applies to dispositions that occur after November 1999.

For taxation years that end after February 27, 2000, the reference in new subsection 93(2.1) to the fraction "3/4" is generally replaced with a reference to the fraction "1/2".

For a taxation year of a corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, that reference to the fraction "1/2" is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Loss Limitations – Disposition of Partnership Interest

ITA
93(2.2)

New subsection 93(2.2) of the Act applies where a corporation resident in Canada or a foreign affiliate of such a corporation has a loss on the disposition of an interest in a partnership that has a direct or indirect interest in shares of a foreign affiliate of the corporation resident in Canada. Where the foreign affiliate has the loss, the rule does not apply where those affiliate shares in which the partnership has an interest would be excluded property of the affiliate if the affiliate owned them immediately before the disposition.

Where the rule applies, the loss arising on the disposition of the partnership interest is reduced by the exempt dividends received before the disposition on the affiliate shares (in which the partnership has the interest) by the particular corporation resident in Canada, a foreign affiliate of the particular corporation, another corporation related to the particular corporation or a foreign affiliate of a corporation resident in Canada that is related to the particular corporation, to the extent that those exempt dividends have not already reduced a capital loss or an allowable capital loss under subsections 93(2) to 93(2.3) arising on other dispositions of property. The term "exempt dividend" is defined in subsection 93(3) of the Act and is modified consequential to the introduction of section 93.1 of the Act.

New subsection 93(2.2) applies to dispositions that occur after November 1999.

For taxation years that end after February 27, 2000, the reference in new subsection 93(2.2) to the expression "4/3 of" is generally replaced with a reference to the word "twice".

For a taxation year of a corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" in subsection 93(2.2) is to be read as reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the taxpayer for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Loss Limitations – Disposition of Partnership Interest by a Partnership

ITA
93(2.3)

New subsection 93(2.3) of the Act applies where a corporation resident in Canada or a foreign affiliate of such a corporation has an allowable capital loss from a partnership arising on the disposition of an interest in a partnership where that partnership (the interest in which is disposed of) has a direct or indirect interest in shares of a foreign affiliate of the corporation resident in Canada. Where the foreign affiliate has the allowable capital loss, the rule does not apply where the affiliate shares in which the partnership (the interest in which was disposed of) has the interest would be excluded property of the affiliate (with the allowable capital loss) if the affiliate had owned the shares.

Where the rule applies, the allowable capital loss from the partnership arising on the disposition of an interest in another partnership which has a direct or indirect interest in the affiliate shares is reduced by 3/4 of the exempt dividends received on the affiliate shares before the time of the disposition by the particular corporation resident in Canada, a foreign affiliate of the particular corporation, another corporation related to the particular corporation or a foreign affiliate of a corporation resident in Canada that is related to the particular corporation, to the extent that those exempt dividends have not already reduced a capital loss or an allowable capital loss under subsections 93(2) to 93(2.3) arising on other dispositions of property. The term "exempt dividend" is defined in subsection 93(3) of the Act and is modified consequential to the introduction of section 93.1 of the Act.

New subsection 93(2.3) applies to dispositions that occur after November 1999.

For taxation years that end after February 27, 2000, the reference in new subsection 93(2.3) the fraction "3/4" is generally replaced with a reference to the fraction "1/2".

For a taxation year of a corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" in subsection 93(2.3) is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Exempt Dividends

ITA
93(3)

Subsection 93(3) of the Act defines the term "exempt dividend" for the purpose of subsection 93(2) of the Act. A dividend received by a Canadian corporation is an exempt dividend to the extent it is deductible under paragraphs 113(1)(*a*), (*b*) or (*c*) of the Act. A dividend received by a foreign affiliate of a Canadian corporation is an exempt dividend to the extent that the portion of the dividend that was not paid out of pre-acquisition surplus exceeds the income or profits tax paid by the affiliate.

Subsection 93(3) is amended to also apply for the purposes of new subsections 93(2.1) to (2.3) of the Act. In addition, the subsection is amended to apply in respect of shares of foreign affiliates that are owed by partnerships. For information on the treatment of foreign affiliate shares owned by partnerships, see the commentary on new section 93.1.

The amendment to subsection 93(3) applies to dispositions that occur after November 1999.

## Clause 71

## Shares Held by a Partnership

ITA
93.1(1)

New subsection 93.1(1) of the Act applies for the purpose of determining whether a non-resident corporation is a foreign affiliate of a corporation resident in Canada for the purposes of new subsection 93.1(2), subsection 20(12), sections 93 and 113 and paragraph 128.1(1)(*d*) and any regulations made for the purposes of those provisions and the rules in section 95 that are required to be applied to a foreign affiliate of a corporation resident in Canada in applying sections 93, 113 and 126 of the Act.

For this purpose, new subsection 93.1(1) deems a member of a partnership to own its proportionate number of shares of a corporation held by a partnership. The number of shares owned by a member at any particular time is equal to the proportion of the total number of shares owned by the partnership that the fair market value of the member's interest in the partnership at that time is of the fair market value of all members' interests in the partnership at that time.

Subsection 93.1(1) applies at any time after November 30, 1999 in determining whether a non-resident corporation is a foreign affiliate of a taxpayer and, where the taxpayer elects in writing and files the election with the Minister of National Revenue before 2002, the subsection also applies after 1972 and before December 1999 in determining whether a non-resident corporation is a foreign affiliate of a taxpayer (other than for the purposes of subsection 20(12) and section 126 of the Act).

### Where Dividends Received by a Partnership

ITA
93.1(2)

New subsection 93.1(2) of the Act applies where a partnership receives a dividend from a foreign affiliate of the corporation resident in Canada.

Paragraph 93.1(2)(*a*) provides that, for the purposes of sections 93 and 113 of the Act and any regulations made for the purposes of those sections, a member of a partnership is treated as having received its proportionate share of a dividend received by the partnership from a foreign affiliate of the member. That proportionate share is determined as that proportion of the partnership dividend that the fair market value of the member's interest in the partnership is of the fair market value of all members' interests in the partnership.

Paragraph 93.1(2)(*b*) provides that, for the purposes of sections 93 and 113 and any regulations made for the purposes of those sections, a dividend that is treated as having been received by a member of a partnership under paragraph 93.1(2)(*a*) is treated as having been received in equal proportions on each affiliate share held by the partnership at that time.

Paragraph 93.1(2)(*c*) provides that, for the purpose of section 113, each affiliate share referred to in paragraph 93.1(2)(*b*) is treated as having been owned by each member of the partnership.

Subparagraph 93.1(2)(*d*)(i) provides that, notwithstanding paragraphs 93.1(2)(*a*), (*b*) and (*c*), where a member of the partnership is a corporation resident in Canada, the maximum amount that the member may deduct under section 113 is restricted to the amount of the dividend received by the partnership that is included in its income under subsection 96(1) of the Act.

Subparagraph 93.1(2)(*d*)(ii) provides that, notwithstanding paragraphs 93.1(2)(*a*), (*b*) and (*c*), where the member is another foreign affiliate of the corporation resident in Canada, the amount included in the other affiliate's income in respect of the dividend referred to in paragraph 93.1(2)(*a*) shall not exceed the amount that would have been included in the other affiliate's income under subsection 96(1) if the value of H in the formula in the definition "foreign accrual property income" in subsection 95(1) were nil and the Act were read without reference to subsection 93.1(2). In effect, the maximum amount that an affiliate can deduct in computing its foreign accrual property income in respect of the dividend referred to in paragraph 93.1(2)(*a*) is restricted to the amount of the dividend included in the affiliate's foreign accrual property income under subsection 96(1).

New subsection 93.1(2) applies to dividends received after November 30, 1999.

## Clause 72

## Application of Certain Provisions to Trusts Not Resident in Canada

ITA
94(1)(*c*)(i)

Where certain conditions are met, a non-resident discretionary trust to which existing section 94 of the Act applies is generally treated as a trust resident in Canada for the purposes of Part I and sections 233.3 and 233.4 of the Act. Under existing subparagraph 94(1)(*c*)(i), the taxable income of such a trust is the total of its taxable income earned in Canada (computed on the assumption that the trust is non-resident) and two additional amounts. The first additional amount for a taxation year is described in clause 94(1)(*c*)(i)(B) as the amount that would be the trust's foreign accrual property income for the year if paragraph 94(1)(*d*) applied. Under clause 94(1)(*c*)(i)(C), the second additional amount for a taxation year is the net amount included under section 91 in computing the trust's income for the year.

Clause 94(1)(*c*)(i)(B) is amended so that the amount determined under that clause in respect of a trust for a taxation year is generally the trust's foreign accrual property income for the year, determined on the assumptions that the trust is a non-resident corporation and that all of the shares of the capital stock of that corporation are owned by a person resident in Canada. Exceptions to this general rule are described below.

Clause 94(1)(*c*)(i)(B) is also amended to clarify that the 21-year deemed disposition rule for trusts applies for the purpose of computing the amount determined under clause 94(1)(*c*)(i)(B), notwithstanding the fact that the rule applies to trusts and not to corporations. This clarification applies to disposition dates determined after 1998.

Subclauses 94(1)(*c*)(i)(B)(II) and (III) are introduced so that, after 1998, dividends from foreign affiliates, and taxable capital gains and allowable losses that relate to "excluded property" (as defined in subsection 95(1)), are included in the trust's foreign accrual property income determined under clause 94(1)(*c*)(i)(B). Because trust income can be distributed as trust capital, it is appropriate to remove the exclusions from foreign accrual property income for dividends and capital gains from excluded property.

Subclause 94(1)(*c*)(i)(B)(IV) is introduced so that section 94.1 is no longer relevant for the purposes of determining the amount under clause 94(1)(*c*)(i)(B). Instead, new clause 94(1)(*c*)(i)(D) adds the amount determined under that section in respect of a trust in computing the trust's taxable income under subparagraph 94(1)(*c*)(i).

Clause 94(1)(*c*)(i)(C) is amended to clarify that the second additional amount added in computing a trust's taxable income under paragraph 94(1)(*c*) is determined by subtracting the amounts deducted in computing income under subsections 91(2), (4) and (5) from the amount added in computing income under subsections 91(1) and (3). This amendment applies to the 1999 and subsequent taxation years.

Clause 94(1)(*c*)(i)(E) (in conjunction with a change to the opening words of subparagraph 94(1)(*c*)(i)) is introduced to provide for a deduction in computing the taxable income for a taxation year of a trust under subparagraph 94(1)(*c*)(i). This deduction is equal to the amount, if any, by which the total of the amounts deducted under subsections 91(2), (4) and (5) in computing the trust's income for the year exceeds the total amount included in computing the trust's income for the year because of subsections 91(1) and (3). Clause 94(1)(*c*)(i)(E) will apply, for example, where an amount was included in computing a trust's taxable income because of clause 94(1)(*c*)(i)(C) and there is subsequently a distribution of dividends to which that amount relates. Clause 94(1)(*c*)(i)(E) is meant to avoid the double taxation of the same income that might otherwise arise. The example below illustrates the operation of clause 94(1)(*c*)(i)(E).

***Example***

*Trust X is a non-resident trust to which paragraph 94(1)(c) applies. Trust X owns 100% of the shares in Foreignco. In year 1, Foreignco's only income is $20,000 of interest income on government bonds. In year 2, Foreignco pays a dividend of $7,000 to Trust X. In year 3, Foreignco pays a dividend of $15,000 to Trust X. Foreignco had no other relevant income in years 2 and 3.*

*Results:*

*1. The taxable income of Trust X for year 1 is calculated under subparagraph 94(1)(c)(i) as follows:*

- *ADD the amount that would be Trust X's "foreign accrual property income" if a number of assumptions were made. Trust X's own foreign accrual property income for year 1 is nil.*[6]

- *ADD the net amount required by section 91 to be included in Trust X's income. This amount is $20,000.*[7]

*As a result, the taxable income of Trust X for year 1 is $20,000.*

*2. The taxable income of Trust X for year 2 is calculated as follows:*

- *ADD the amount that would be Trust X's "foreign accrual property income" if a number of assumptions were made. Because of subclause 94(1)(c)(i)(B)(II), dividends received by affiliates are included in computing Trust X's foreign accrual property income for this purpose. Consequently, Trust X's "foreign accrual property income" is $7,000.*

- *SUBTRACT the net amount deducted under section 91 in computing the trust's income.*[8] *The deduction available is equal to the lesser of the amount of the dividend ($7,000) and the net adjusted cost base adjustments ($20,000) up to the time the $10,000 dividend is paid.*[9] *Consequently, the full $7,000 is deducted because of clause 94(1)(c)(i)(E).*

*As a result, the taxable income of Trust X for year 2 is nil.*

*3. The taxable income of Trust X for year 3 is calculated as follows:*

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[6] Clause 94(1)(c)(i)(B), in conjunction with definition of "foreign accrual property income" in subsection 95(1).

[7] Clause 94(1)(c)(i)(C), in conjunction with subsection 91(1).

[8] Clause 94(1)(c)(i)(E).

[9] Subsection 91(5).

- *ADD the amount that would be Trust X's "foreign accrual property income" if a number of assumptions were made. Because of subclause 94(1)(c)(i)(B)(II), dividends received by affiliates are included in computing Trust X's foreign accrual property income for this purpose. Consequently, Trust X's "foreign accrual property income" is $15,000.*

- *SUBTRACT the net amount deducted under section 91 in computing the trust's income.*[10] *The deduction available is equal to the lesser of the amount of the dividend ($15,000) and the net adjusted cost base adjustments ($20,000 - $7,000) up to the time the $15,000 dividend is paid.*[11] *Consequently, $13,000 is deducted because of clause 94(1)(c)(i)(E).*

  *As a result, the taxable income of Trust X for year 2 is $2,000.*

These amendments come into effect in the manner indicated in the commentary above and apply to the 1999 and subsequent taxation years. However, as announced in the 1999 budget, further amendments to this section are contemplated.

ITA
94(1)(*c*)(ii)

Subparagraph 94(1)(*c*)(ii) of the Act is relevant for the purpose of determining the foreign tax credit of a trust to which paragraph 94(1)(*c*) applies. For this purpose, the trust's income is generally deemed to be from sources in the country in which the trust would be resident if that paragraph did not apply. However, subparagraph 94(1)(*c*)(ii) does not apply in connection with taxable income calculated under clause 94(1)(*c*)(i)(A) (taxable income earned in Canada).

Subparagraph 94(1)(*c*)(ii) is amended to reflect the amendments to subparagraph 94(1)(*c*)(i). Under amended subparagraph 94(1)(*c*)(ii), the portion of the taxable income sourced for the purposes of the foreign tax credit is equal to amount that would be the trust's taxable income calculated under subparagraph 94(1)(*c*)(i) if the trust's taxable income earned in Canada were not taken into account.

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[10] Clause 94(1)(c)(i)(E).
[11] Subsection 91(5).

This amendment applies to the 1999 and subsequent taxation years. However, as announced in the 1999 budget, further amendments to section 94 are contemplated.

## Clause 73

### Foreign Affiliates

ITA
95

Section 95 of the Act defines a number of terms and provides certain rules relating to the taxation of resident shareholders of foreign affiliates.

### Definitions

ITA
95(1)

"foreign accrual property income"

The description of A.1 in the definition "foreign accrual property income" in subsection 95(1) of the Act includes in the foreign accrual property income of a foreign affiliate of a taxpayer 4/3 of the amount required in respect of a debt settlement to be added to the affiliate's income because of subsection 80(13) of the Act.

The description of A.1 is amended to replace the reference to the expression "4/3 of" with a reference to the word "twice". The change is consequential to the reduction of the capital gains inclusion rate from 3/4 to 1/2.

The amendment generally applies to taxation years that end after February 27, 2000 except that, where the affiliate's taxation year includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" in the description of A.1 in the definition "foreign accrual property income" in subsection 95(1) is to be read as a reference the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the foreign affiliate for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

The description of F in the definition "foreign accrual property income" in subsection 95(1) of the Act and section 5903 of the *Income Tax Regulations* establish the extent to which a foreign affiliate of a taxpayer is permitted to deduct amounts in computing its foreign accrual property income for the year in respect of foreign accrual property losses of other taxation years. Under the existing provisions such losses may be carried forward for five years.

The amendments to the description of F in the definition "foreign accrual property income" in subsection 95(1) of the Act and section 5903 of the Regulations provide that foreign accrual property losses may be carried back three years and forward seven years. The amendments to the description of F apply to taxation years of a foreign affiliate that begin after November 1999

The amendment to the definition of "foreign accrual property income" in subsection 95(1) of the Act adds new description H to the formula in that definition. The description of H applies where the affiliate was a member of a partnership that received a dividend from another foreign affiliate of the taxpayer. In such a case, the amount for the description of H is equal to the portion of such dividend received by the partnership that is included in the description of A in the formula in respect of the affiliate for the year that is deemed by paragraph 93.1(2)(*a*) of the Act to have been a dividend received by the member affiliate from another foreign affiliate of the taxpayer. New description H ensures that inter-affiliate dividends are not included in foreign accrual property income of an affiliate of the taxpayer.

The addition of description H to the definition "foreign accrual property income" in subsection 95(1) is applicable after November 1999.

### Canadian-Source Income

ITA
95(2)(*a*.3)

Subsection 95(2) of the Act provides rules for determining the income of a foreign affiliate of a taxpayer resident in Canada from a particular source. Paragraph 95(2)(*a*.3) includes in the income from a business other than an active business – and thus the foreign accrual property income – of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate derived directly or indirectly from most forms of indebtedness or lease obligations of persons resident in Canada or in respect of businesses carried on in Canada. Currently excluded from the income treated in this way is income that derives from a specified deposit with a prescribed financial institution. Paragraph 95(2)(*a*.3) is amended to refer to the new concepts excluded income and excluded revenue, which are defined in subsection 95(2.5). These terms encompass the existing exclusion relating to specified deposits and two new exclusions:

- Income or revenue derived directly or indirectly from a lease obligation that relates to the use of property outside Canada by a person who deals at arm's length with the taxpayer.

- Income or revenue that is earned in a business carried on by the affiliate through a permanent establishment in Canada. Such business income is already subject to full Canadian taxation, and need not be added to the affiliate's income under this provision.

This amendment applies to taxation years of foreign affiliates that begin after 1999, though a taxpayer may elect to have the amendment apply to taxation years, of all the taxpayer's foreign affiliates, that begin after 1994.

### Certain Foreign Currency Gains and Losses of a Foreign Affiliate

ITA
95(2)(*g*) and (*h*)

Paragraph 95(2)(*g*) provides that foreign currency gains or losses realized on the settlement of debts owing between foreign affiliates or between a foreign affiliate and a non-arm's length non-resident corporation are ignored for the purpose of determining foreign accrual property income ("FAPI"). Similarly, paragraph 95(2)(*h*) allows foreign currency gains or losses to be ignored for the purpose of determining FAPI when realized by a foreign affiliate as a result of the redemption, cancellation or acquisition of shares of, or on the reduction of capital of, another foreign affiliate of the taxpayer. Paragraph 95(2)(*h*) also allows foreign currency gains or losses to be ignored when realized on a non-arm's length sale of shares of another affiliate.

The amendment to paragraph 95(2)(*g*) incorporates the provisions of paragraphs 95(2)(*g*) and (*h*) into one paragraph. Also, the amendment allows paragraph 95(2)(*g*) to apply regardless of whether the foreign currency gains or losses are incurred on income or capital account or are accrued or realized. As well, paragraph 95(2)(*g*) applies in circumstances where the foreign affiliate redeems, cancels or acquires its own shares. In light of the foreign corporate group concept adopted in paragraph 95(2)(*a*) as part of the 1994 budget amendments, the relief in paragraph 95(2)(*g*) is restricted to circumstances where the taxpayer resident in Canada has a qualifying interest in each relevant foreign affiliate. In addition, each qualified non-resident corporation must be a corporation that is related to the taxpayer and the affiliate benefiting from the relief of paragraph 95(2)(*g*).

The amendment to paragraph 95(2)(*g*) applies to taxation years of a foreign affiliate that begin after November 1999. However, if the taxpayer so elects in writing and files the election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxation year that includes the day on which this amendment receives Royal Assent, paragraph 95(2)(*g*) applies to of all its foreign affiliates' taxation years that begin after 1994.

### Foreign Spin-off Election

ITA
95(2)(*g*.2)

New paragraph 95(2)(*g*.2) of the Act is added as a consequence of the introduction of the foreign spin-off tax-deferral rules in new section 86.1. Paragraph 95(2)(*g*.2) applies for the purpose of computing the foreign accrual property income of a foreign affiliate of any taxpayer resident in Canada for a taxation year of the affiliate. New paragraph 95(2)(*g*.2) deems an election pursuant to paragraph 86.1(2)(*f*) in respect of a distribution received by the foreign affiliate (in a particular taxation year of the affiliate) to have been filed under that paragraph in two cases.

First, where there is only one taxpayer resident in Canada in respect of whom the foreign affiliate is a controlled foreign affiliate, section 86.1 applies to the distribution received by the foreign affiliate if the election is filed by that taxpayer with the taxpayer's return of income for the taxpayer's taxation year in which the taxation year of the affiliate ends.

Second, where there is more than one taxpayer resident in Canada in respect of whom the affiliate is a controlled foreign affiliate, section 86.1 applies to the distribution received by the foreign affiliate if the election is filed by one such taxpayer and all such taxpayers so agree in writing and file that agreement and the election with the Minister in each of their returns of income for their taxation year in which the taxation year of the affiliate ends.

For more detail in respect of the foreign spin-off rules, see the commentary on new section 86.1.

New paragraph 95(2)(*g*.2) applies, in general, to distributions received after 1997.

### Rule for Subsection (2)

ITA
95(2.2)

Subsection 95(2.2) of the Act provides rules for the purpose of paragraph 95(2)(*a*) of the Act. The subsection provides that in certain circumstances a non-resident corporation that was not a foreign affiliate of a taxpayer will be considered to be a foreign affiliate of the taxpayer. It also provides that in certain circumstances a non-resident corporation that was not related to a foreign affiliate of a taxpayer will be considered to be related to the foreign affiliate and the taxpayer.

Subsection 95(2.2) is amended to apply to all of subsection 95(2), rather than only for paragraph 95(2)(a). This amendment ensures that subsection 95(2.2) will apply to the changes in paragraph 95(2)(*g*) of the Act and has the same effective date as those changes.

## Definitions

ITA 95(2.5)

Subsection 95(2.5) of the Act sets out definitions that apply for the purpose of paragraph 95(2)(*a*.3).

The new definitions "excluded income" and "excluded revenue" in respect of a foreign affiliate of a taxpayer mean, respectively, income or revenue:

- derived directly or indirectly from a specified deposit with a prescribed financial institution (as defined in section 7900 of the *Income Tax Regulations*),
- derived directly or indirectly from a lease obligation that relates to the use of property outside Canada by a person who deals at arm's length with the taxpayer, or
- earned in a business carried on by the affiliate through a permanent establishment in Canada.

This amendment applies to taxation years of foreign affiliates that begin after 1999, though a taxpayer may elect to have the amendment apply to taxation years, of all the taxpayer's foreign affiliates, that begin after 1994.

## Where Rights or Shares are Issued, Acquired or Disposed of to Avoid Tax

ITA
95(6)

Subsection 95(6) of the Act is an anti-avoidance rule that prevents the avoidance of tax through the use of rights to acquire shares or the issuance of shares. The amendments to this subsection clarify that the subsection is intended to prevent the avoidance of tax through the use of rights to acquire partnership interests or the issuance of partnership interests. Where applicable, paragraph 95(6)(*b*) treats an acquisition or disposition of shares or partnership interests to have not taken place. Where the shares or partnership interests were previously unissued, the paragraph deems the shares or partnership interests to have not been issued.

The amendments to subsection 95(6) are applicable after November 1999.

## Clause 74

### Partnerships and Their Members

ITA
96

Section 96 of the Act provides general rules for determining the income or loss of a partnership and its members.

### General rules

ITA
96(1)(*d*)

Under subsection 96(1) of the Act, the income earned and the losses incurred by a partnership are generally calculated at the partnership level and attributed to partners in accordance with their respective interests. However, under paragraph 96(1)(*d*) the income or loss of a partnership is computed without reference to a number of provisions including various provisions relating to resource income and expenditures.

Paragraph 96(1)(*d*) is amended so that income inclusions under subsection 59(1) (dispositions of foreign resource property) and paragraph 59(3.2)(*c*.1) are ignored for this purpose. Instead, under new subsections 59(1.1) and 66(12.42), there is a flow-through to a member of a partnership of the member's share of proceeds of disposition of foreign resource property and of other relevant amounts receivable.

Paragraph 96(1)(*d*) is also amended to ignore deductions under new section 66.21, given that a partner's share of foreign resource expenses qualifies under paragraph (*e*) of the definition "foreign resource expense" in subsection 66.21(1) as the partner's own foreign resource expenses.

These amendments apply to fiscal periods that begin after 2000.

### Gains and Losses

ITA
96(1.7)

Subsection 96(1.7) of the Act applies to a taxpayer other than an individual who is not a testamentary trust and adjusts the amount of a partnership's taxable capital gain or allowable capital loss included in a taxpayer's income where the taxpayer's capital gains inclusion rate for the taxpayer's taxation year in which the partnership's fiscal period ends is different from the partnership's inclusion rate used to calculate the partnership's taxable capital gain or allowable capital loss.

The adjusted taxable capital gain or allowable capital loss reflects the taxpayer's inclusion rate for the taxpayer's taxation year in which the fiscal period of the partnership ends. This is necessary since a taxpayer may have other taxable capital gains or allowable capital losses and all taxable capital gains and allowable capital losses should be calculated using the same inclusion rate.

The subsection is amended to make the subsection apply in respect of all taxpayers and change the references to subsection 14(1) with references to subsection 14(1.1). The amendment applies to the 2000 and subsequent taxation years that end after February 27, 2000.

### Gains and Losses

ITA
96(1.71)

Section 96 is amended by adding the new subsection (1.71) after subsection (1.7).

Where the fraction referred to in the description of C in subsection (1.7) is not determinable by a taxpayer in respect of a fiscal period of a partnership that ends before February 28, 2000 or includes either

February 28, 2000 or October 17, 2000, for the purposes of subsection (1.7) the fraction is deemed to be 3/4 where the fiscal period ended before or began before February 28, 2000. Where the fiscal period began after February 27, 2000 and before October 18, 2000, the fraction is deemed to be 2/3, and in any other case, the fraction is deemed to be 1/2.

**Limited Partnership Losses**

ITA
96(2.1)(*b*)(iv)(A)

Subsection 96(2.1) of the Act deals with the losses of limited partnerships. That subsection generally limits the deduction by a limited partner of losses to an amount equal to the amount by which the limited partner's "at-risk amount" in respect of a partnership exceeds the partner's share of specified resource expenditures flowed-through to the partner. Under clause 96(2.1)(*b*)(iv)(A), the resource expenditures specified include foreign exploration and development expenses.

Clause 96(2.1)(*b*)(iv)(A) is amended to specify "foreign resource pool expenses", as newly defined in subsection 248(1), rather than only foreign exploration and development expenses. The new definition "foreign resource pool expenses" includes both foreign exploration and development expenses (as defined in subsection 66.21(1)) and expenses that are a foreign resource expense (as defined in subsection 66.21(1)).

This amendment applies to fiscal periods that begin after 2000.

**Limited Partner**

ITA
96(2.4)

Subsection 96(2.4) of the Act provides an extended definition of "limited partner" that is relevant for the purpose of applying the restrictions on partnership tax credits and losses.

Paragraph 96(2.4)(*a*) provides that a member of a partnership is a "limited partner" if, by operation of any law governing the partnership arrangement, the liability of the member as a member of the partnership is limited. Concern has been expressed that paragraph 96(2.4)(*a*) applies to a partner of a "limited liability partnership" in addition to a limited partner of a limited partnership. A limited liability partnership is a new type of partnership the form of which has only recently been permitted under some provincial statutes.

Unlike a limited partner of a limited partnership, a member of limited liability partnership can be liable for the general debts and obligations of a limited liability partnership. However, a member of a limited liability partnership is not liable for the debts, obligations and liabilities of the partnership, or any member of the partnership, arising from negligent acts or omissions that another member of the partnership or an employee, agent or representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership.

Paragraph 96(2.4)(*a*) is amended to exclude from its application cases where a member's liability is limited by operation of a statutory provision of Canada or a province that limits the member's liability only for the debts, obligations and liabilities of a limited liability partnership, or any member of the partnership, arising from negligent acts or omissions that another member of the partnership or an employee, agent or representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership.

This amendment applies after 1997.

### Agreement or Election of Partnership

ITA
96(3)

Subsection 96(3) of the Act provides rules that apply if a member of a partnership makes an election under certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. In such a case, the election is valid only if it is made on behalf of all members of the partnership and the member had authority to act for the partnership. Subsection 96(3) is amended consequential to the foreign spin-off rules in new section 86.1. While new section 86.1 applies in respect of distributions made after 1997, the election referred to in that section cannot be made until 2000 at the earliest. Accordingly, the amendment to subsection 96(3) applies after 1999.

## Clause 75

## Disposition of Partnership Property

ITA
98

Section 98 provides rules relating to the taxation of partnership properties and partnership interests where the partnership has ceased to exist.

ITA
98(3)

Subsection 98(3) of the Act is an elective provision permitting property of a Canadian partnership which has ceased to exist to be distributed to its members, for proceeds to the partnership and at a cost to the members, equal to the cost amount of the property to the partnership, provided certain conditions are met. Where those conditions are met, this provision allows a special increase or "bump-up" in the tax value of the distributed partnership property where the adjusted cost base of a member's partnership interest exceeds the amount of any money and the cost amount to the partnership of the property which the member has received upon the dissolution.

Subparagraph 98(3)(*g*)(iii) prevents an overstatement of the income inclusions under existing subparagraph 14(1)(*a*)(v) and existing paragraph 14(1)(*b*) of the Act. Subparagraph 98(3)(*g*)(iii) is amended consequential to the re-numbering of subsection 14(1), which is described in further detail in the commentary to that subsection.

This amendment applies to taxation years that end after February 27, 2000.

ITA
98(5)

Subsection 98(5) of the Act contains rules which provide a tax-deferred transfer or "rollover" of a Canadian partnership's property where the partnership has ceased to exist and the transfer is to one member of the partnership who continues to carry on the business of the partnership as a sole proprietor.

Where the adjusted cost base of the member's partnership interest, including the interests acquired from other members, exceeds the amount of any money and the cost amount to the partnership of the property received by the proprietor upon the dissolution, the member may designate this excess to be added to the cost base of one of more particular properties.

Subparagraph 98(5)(*h*)(ii) prevents an overstatement of the income inclusions under subparagraph 14(1)(*a*)(v) or paragraph 14(1)(*b*) of the Act. Subparagraph 98(5)(*h*)(ii) is amended consequential to the re-numbering of subsection 14(1), which is described in further detail in the commentary to that subsection.

This amendment applies to taxation years that end after February 27, 2000.

## Clause 76

## Disposition of an Interest in a Partnership

ITA
100(1)(*a*)

Subsection 100(1) of the Act provides a rule for the purpose of determining a taxpayer's gain from the disposition of an interest in a partnership to a person part or all of whose taxable income is exempt from tax under section 149 of the Act.

Paragraph 100(1)(*a*) is amended to replace the reference to the fraction "3/4" with a reference to the fraction "1/2". The change is consequential to the reduction in the capital gains inclusion rate.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a taxpayer that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" in paragraph 100(1)(*a*) is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Clause 77

## Disposition of Farmland by Partnership

ITA
101

Section 101 of the Act provides for a deduction in computing the income of a taxpayer for a taxation year of the taxpayer in which a fiscal period of a partnership ends where, in that fiscal period, the partnership has sold land used in farming. The deduction is equal to 3/4 of the farm losses that, because of section 31, were not deductible and that relate property taxes in respect of and interest on money borrowed to acquire the farmland sold. The amendments to subsection 101(1) replace the reference to the fraction "3/4" with a reference to the fraction "1/2" and the reference to the expression "4/3 of" with references to the word "twice". The changes are consequential to the reduction of the capital gains inclusion rate from 3/4 to 1/2.

The amendments apply to taxation years that end after February 27, 2000 except that, where the taxation year of the partnership that ends in the taxation year of the taxpayer includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" in subsection 101(1) is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the taxpayer's taxation year in which the taxation year of the partnership ended. The reference to the word "twice" in subsection 101(1) is to be read as a reference the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the partnership for the fiscal period, multiplied by".

## Clause 78

### Trusts and Their Beneficiaries

ITA
104

Section 104 of the Act provides rules governing the tax treatment of trusts and their beneficiaries.

ITA
104(1) and (1.1)

Subsection 104(1) of the Act provides a rule under which a reference to a trust or estate is read in the Act as a reference to the trustee or the executor, administrator, heir or other legal representative having ownership or control over trust property.

Subsection 104(1) is amended to include a "liquidator of the succession" to the list of persons to which a trust or estate refers for the purposes of the Act. This amendment is made to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

Subsection 104(1) is amended so that this rule does not apply where the context otherwise requires and to clarify that this rule is meant to be a convenient way of linking the trustees and others described in the subsection with a trust for the purposes of the Act. This amendment recognizes that there are references to "trust" in the Act that are meant to indicate a trust arrangement, rather than the persons who are responsible for the operation of the arrangement. The latter references include those found in subsections 74.4(4), 104(5.3) and (5.5), 108(6) and 127(7).

Subsection 104(1) is amended, in conjunction with 104(1.1), so that, except for the purposes of those two subsections, subparagraph (*b*)(v) of the definition "disposition" in subsection 248(1) and paragraph (*k*) of that definition, references in the Act to trusts are considered not to include an arrangement where a trust can reasonably be considered to act as agent for its beneficiaries with respect to all dealings in all of the trust's property. These arrangements are generally known as "bare trusts". Trusts described in paragraphs (*a*) to (*e*.1) of the definition "trust" in subsection 108(1) are expressly not affected by this amendment.

New subsection 104(1.1) applies for the purpose of identifying beneficiaries under a trust for the purpose of subsection 104(1), as well as for the purposes of subparagraph 73(1.02)(*b*)(ii) and paragraphs 104(4)(*a*.4) and 107.4(1)(*e*). A person or partnership is deemed not to be a beneficiary under a trust at a particular time for these purposes where the person or partnership is beneficially interested in the trust at the particular time solely because of any one, or a combination of, the following:

- a right that may arise as a consequence of the terms of the will or other testamentary instrument of an individual who, at the particular time, is a beneficiary under the trust;

- a right that may arise as a consequence of the law governing the intestacy of an individual who, at the particular time, is a beneficiary under the trust;

- a right as a shareholder under the terms of the shares of the capital stock of a corporation that, at the particular time, is a beneficiary under the trust; or

- a right as a member of a partnership under the terms of the partnership agreement, where, at the particular time, the partnership is a beneficiary under the trust.

These amendments generally apply to the 1998 and subsequent taxation years. However, in order to co-ordinate this amendment with changes to the replacement of the definition "disposition" in section 54 with the new definition of the same expression in subsection 248(1), it does not apply in connection with transfers of property that occurred before December 24, 1998.

ITA
104(4) to (5.2)

Subsections 104(4) to (5.2) of the Act set out what is generally referred to as the "21-year deemed realization rule" for trusts. The purpose of the rule is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital properties, resource properties and land inventories. These subsections generally treat such properties as having been disposed of and reacquired by trusts (other than certain trusts for the benefit of a spouse or common-law partner) every 21 years at the properties' fair market value. The first deemed disposition day for post-1971 spousal or common-law partner trusts, as provided under paragraph 104(4)(*a*), is the day on which the spouse or common-law partner beneficiary dies. The fair market value of property that is deemed to be disposed of on a day determined under paragraph 104(4)(*a*) or (*a*.1), is determined with reference to the valuation rule for insurance policies in amended subsection 70(5.3) (see the commentary above on that provision).

Subsections 104(4) to (5.2) are amended so that the deemed realization rules do not apply to "exempt property" of a non-resident trust, as the expression is now defined in subsection 108(1). "Exempt property" is defined as property the income or gain from the disposition of which by a taxpayer is exempt from Canadian taxation for the taxpayer either because the taxpayer is not resident in Canada or because of a tax treaty. The purpose of this amendment is to prevent the deemed realization rules from being used to increase the cost of such property. The increased cost might be relevant in the event that a non-resident trust distributes such property to Canadian beneficiaries. These amendments apply to deemed disposition days that are after December 23, 1998. In the case of capital property (other than depreciable property), the amendments also apply to deemed disposition days that are after 1992, but only for the purpose of determining after December 23, 1998 the cost amount to a trust of property.

Paragraph 104(4)(*a*) is amended to provide the first deemed disposition day in respect of an *inter vivos* trust created after 1999 that at any time after 1999 was a trust for the exclusive benefit of the settlor during the settlor's lifetime (i.e., an "*alter ego* trust", as newly defined in subsection 248(1)) or a trust for the joint benefit of the settlor and the settlor's spouse or common-law partner during their lifetimes (i.e., a "joint spousal or common-law partner trust", as newly defined in subsection 248(1)). The first deemed disposition date in these circumstances, in the event that the settlor was at least 65 years of age at the time of the settlement, is generally the day on which the settlor dies (or, in the case of a trust for the joint benefit of the settlor and spouse or common-law partner, the day on which the survivor dies). However, where a trust that would otherwise be an *alter ego* trust so elects under subparagraph 104(4)(*a*)(ii.1), the first deemed disposition date of the trust will generally be the 21st anniversary of the creation of the trust, as determined under paragraph 104(4)(*b*). This amendment applies to the 2000 and subsequent taxation years. For an explanation of the age 65 restriction, see the commentary on new subsection 73(1.02).

Paragraph 104(4)(*a*.2) is introduced to provide for a deemed disposition day for a trust that distributes property financed by a liability of the trust. This measure only applies, however, if one of the purposes of the transaction was to avoid taxes otherwise payable as a consequence of the death of an individual. The deemed disposition under this paragraph occurs immediately after the distribution of the property (as the determination is made as if a day had ended immediately after each distribution). This amendment applies to deemed disposition days determined after December 17, 1999.

Paragraph 104(4)(*a*.3) is introduced to provide for a deemed disposition day for a trust in the event that an individual, after December 17, 1999, has transferred property to the trust in circumstances to which subsection 73(1) applies, it is reasonable to conclude that the property was so transferred in anticipation that the taxpayer would subsequently cease to reside in Canada and the individual subsequently ceases to reside in Canada. This measure does not apply, however, to property transferred that is exempt under amended subparagraphs 128.1(4)(*b*)(i) to (iii) from a deemed disposition on the transferor's emigration. The deemed disposition under paragraph 104(4)(*a*.3) occurs immediately after the individual ceases to be resident in Canada. This amendment applies to deemed disposition days determined after December 17, 1999.

Paragraph 104(4)(*a*.4) is introduced to provide the first deemed disposition day in respect of an *inter vivos* trust to which property was transferred by a taxpayer who is an individual (other than a trust) in circumstances in which section 73 or subsection 107.4(3) applied. Where the transfer does not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)), the first deemed disposition date of the trust property is the day on which the taxpayer dies. This amendment applies to the 2000 and subsequent taxation years, and, where a trust elects in writing and files the election with the Minister of National Revenue on or before March 31, 2001 (or at a later time that is acceptable to the Minister), the amendment applies to days after December 23, 1998. For more detail on section 73, subsection 104(1.1) or section 107.4, see the commentary on those provisions.

Paragraph 104(4)(*b*) of the Act provides for a deemed disposition of the property of certain trusts at the end of the day that is the 21 years after the latest of January 1, 1972, the day on which the trust was created, and, where applicable, the day determined under paragraph 104(4)(*a*) or (*a*.1) as those paragraphs applied from time to time after 1971. Subparagraph 104(4)(*b*)(iii) of the Act is amended to add a reference to new paragraph 104(4)(*a*.4). This will ensure that the first deemed disposition day of a trust that is determined under subsection 104(4) and that is after the day determined under paragraph 104(4)(*a*.4) in respect of the trust generally will be the day that is 21 years after the day determined under paragraph 104(4)(*a*.4). This amendment applies to the 2000 and subsequent taxation years, and, where a trust elects in writing and files the election with the Minister on or before March 31, 2001 (or at any later time that is acceptable to the Minister), to days after December 23, 1998. For more detail on section 73 or subsection 104(1.1) or 107.4(3), see the commentary on those provisions.

Paragraph 104(4)(*c*) is amended so that there is not a deemed disposition day for a trust 21 years after any day determined under new paragraph 104(4)(*a*.2), (*a*.3) or (*a*.4). This amendment applies to the 2000 and subsequent taxation years.

Subsection 104(5.2) of the Act provides that each Canadian resource property and foreign resource property of a trust is treated, for specified purposes, as having been disposed of immediately before the end of a day determined under subsection 104(4) for fair market value proceeds. For the purposes of specified resource provisions, the trust is treated as having a taxation year (referred below to as the "notional year") ending at the end of such a day for the purpose of computing the amount to be included in its income as a result of this disposition of the resource properties. The Canadian and foreign resource properties are deemed to be reacquired immediately after notional year for the same amount.

Paragraph 104(5.2)(*a*) is amended to include references to new paragraph 59(3.2)(*c*.1) and the new definition "cumulative foreign resource expense" in new section 66.21 in the resource provisions specified under subsection 104(5.2).

Paragraph 104(5.2)(*b*) is amended so that any resulting income inclusion under new paragraph 59(3.2)(*c*.1) with regard to the notional year is added in determining the trust's cumulative foreign resource expense at the end of the trust taxation year of which the notional year is part. This amendment ensures that there is no double taxation in respect of the same economic gain and is consistent with the treatment of resulting income inclusions with regard to Canadian resource properties.

The effect of these amendments is that the fair market value of a foreign resource property can, to the extent proceeds are designated under new subparagraph 59(1)(*b*)(ii), reduce a trust's cumulative foreign resource expense. If a negative balance results, the negative balance is included in income under paragraph 59(3.2)(*c*.1) and added in computing the trust's cumulative foreign resource expense after the end of the notional year.

Except as otherwise provided, the amendments to subsection 104(5.2) apply to taxation years that begin after 2000.

These amendments also reflect changes effected by the *Modernization of Benefits and Obligations Act*.

ITA
104(5.3)(*c*) and (*d*)

Subsection 104(5.3) of the Act allowed the deferral of the 21-year deemed disposition date (determined under paragraph 104(4)(*a*.1) or (*b*)) for certain family trusts. The measure has already been terminated under the existing rules, so that the deferred disposition date was no later than January 1, 1999.

Subject to paragraph 104(5.3)(*d*), paragraph 104(5.3)(*c*) ensures that the deemed disposition date cannot be deferred beyond

January 1, 1999 (or an earlier date, where applicable) through a transfer of property from one trust to another that does not constitute a "disposition" because of existing paragraph (*e*) of the definition "disposition" in section 54.

Any trust-to-trust transfer in the period (referred to below as the "relevant period") that is after the original date of the deemed disposition and before the date of the deferred deemed disposition is considered to be a "disposition" (i.e., a taxable event) for a trust that has made an election under subsection 104(5.3). Paragraph 104(5.3)(*d*) provides for relief from paragraph 104(5.3)(*c*) where, essentially, one trust is replaced by another trust with the same terms and beneficiaries. In this case, the new trust is deemed to be the same trust as, and a continuation of, the original trust.

Paragraph 104(5.3)(*c*) is amended to eliminate the reference to the existing definition of "disposition" in section 54, as a consequence of the repeal of that definition and its replacement by a new definition of "disposition" in subsection 248(1).

Paragraph 104(5.3)(*c*) is also amended so that it only applies where there is a "disposition" of property (as now defined in subsection 248(1)). The only relevant "trust-to-trust" transfer where there is no "disposition" is one to which paragraph (*f*) of the new definition "disposition" applies. Where paragraph (*f*) of that definition applies, the transferee trust is considered under subsection 248(25.1) to be the same as and a continuation of the transferor trust.

Paragraph 104(5.3)(*d*) is repealed, consequential to the introduction of paragraph (*f*) of the new definition "disposition" and new subsection 248(25.1).

These amendments apply to transfers made after December 23, 1998.

ITA
104(5.8)

Subsection 104(5.8) of the Act is a special rule designed to prevent the avoidance of the 21-year rule through the use of trust-to-trust transfers that do not involve dispositions of property at fair market value. Subsection 104(5.8) generally provides for a transferee trust to assume the next deemed disposition day of the transferor, if that day is earlier than the transferee's next deemed disposition day. In the case of trusts for the benefit of a spouse or common-law partner under which the beneficiary spouse or common-law partner is still alive, subsection 104(5.8) provides a deemed disposition as soon as the transfer is completed unless relief is provided under paragraph 104(5.8)(*b*). Paragraph 104(5.8)(*b*) provides relief where both the transferor and transferee trusts are trusts to which paragraph 104(4)(*a*) or (*a*.1) applies and under which the spouse or common-law partner beneficiary is alive.

Subsection 104(5.8) is amended to eliminate a reference to trust transfers under paragraph (*e*) of the definition "disposition" in section 54, as a consequence of the repeal of that definition. Subsection 104(5.8) is also amended so that it now covers transfers under new paragraph (*f*) of the definition "disposition" in subsection 248(1) and under new subsection 107.4(3). These amendments apply to transfers made after December 23, 1998.

Subsection 104(5.8) is amended so that it does not apply to transfers between trusts, if the transferee trust was, at the time of the transfer, described in paragraph (*g*) of the definition "trust" in subsection 108(1). This amendment, which is made as a consequence of the introduction of subparagraph (*g*)(iv) of that definition, applies only to transfers made after February 11, 1991 and before December 24, 1998. Subparagraph (*g*)(iv) of that definition has the effect of limiting an exemption from the 21-year deemed disposition rule for a trust in which interests are vested indefeasibly, in the event that non-resident beneficiaries own more than 20% of the interests in the trust.

Subparagraph 104(5.8)(*a*)(i) is amended to ensure that the determination of a deemed disposition day for a transferee trust will not preclude any earlier deemed disposition day under new paragraph 104(4)(*a*.2) or (*a*.3). This amendment applies to transfers made after December 17, 1999.

Subsection 104(5.8) is further amended to extend its existing rules for transfers from trusts for the benefit of a spouse or common-law partner to transfers from other specified trusts. The additional trusts so specified are:

- those created after 1999 by a settlor (aged 65 years or more) for the exclusive benefit of the settlor during the settlor's lifetime (i.e., an "*alter ego* trust", as newly defined in subsection 248(1)) or for the joint benefit of the settlor and the settlor's spouse or common-law partner during their joint lifetimes (i.e., a "joint spousal or common-law partner trust", as newly defined in subsection 248(1)); and

- trusts to which paragraph 104(4)(*a*.4) applies (i.e., a trust to which property was transferred by a taxpayer who is an individual (other than a trust) in circumstances in which section 73 or subsection 107.4(3) applied, where the transfer does not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)).

Where the settlor of an *alter ego* trust is still alive (or, in the case of a joint spousal or common-law partner trust, where the settlor or the spouse or common-law partner is still alive), a deemed disposition day for the trust may occur once a transfer from the trust is completed. However, amended paragraph 104(5.8)(*b*) and new paragraphs 104(5.8)(*b*.1) to (*b*.3) provide for no deemed disposition day in the case of a transfer from one of the additional specified trusts where the transferee trust is the same type of specified trust to which paragraph 104(4)(*a*) or (*a*.4), as the case may be, applies and the settlor (or, in the case of a joint spousal or common-law partner trust, either the settlor or that spouse or common-law partner) or taxpayer, as the case may be, is alive. These amendments apply to transfers made after 1999. For further detail on new rules for *alter ego* trusts and joint spousal or common-law partner trusts, see the commentary on amended subsection 73(1) and paragraph 104(4)(*a*). For further detail on paragraph 104(4)(*a*.4), see the commentary on that paragraph.

These amendments also reflect changes effected by the *Modernization of Benefits and Obligations Act*.

ITA
104(6)

Subsection 104(6) of the Act generally allows a trust to deduct an amount for a taxation year not exceeding its income for the year that became payable to its beneficiaries. However, in the case of a trust for the benefit of a spouse or common-law partner there are restrictions designed to ensure that the trust cannot claim a deduction under subsection 104(6) in respect of income allocated to non-spouse or non-common-law partner beneficiaries to the extent the income accrues during the lifetime of the spouse or common-law partner beneficiary. (With regard to income for the year in which a spouse or common-law partner beneficiary dies, this restriction only applies in connection with income from dispositions of capital property, land inventory and Canadian and foreign resource property that occur before the end of the deemed disposition day caused by the death of the spouse or common-law partner.) There is also a restriction in subsection 104(6) designed to limit the extent to which a trust can claim a deduction in respect of distributions by the trust of amounts paid to the trust from the trust's NISA Fund No. 2 (as defined in subsection 248(1)).

Paragraph 104(6)(*a*.3) is introduced so that the restrictions with regard to a trust's NISA Fund No. 2 do not apply to any trust deemed to exist because of the special rules for communal organizations in section 143. This amendment applies to the 1998 and subsequent taxation years.

Paragraph 104(6)(*b*) is amended to extend the restrictions for a trust for the benefit of a spouse or common-law partner to other specified trusts. The trusts so specified are:

- trusts created after 1999 by a settlor (aged 65 years or more) for the exclusive benefit of the settlor during the settlor's lifetime (i.e., an "*alter ego* trust", as newly defined in subsection 248(1)) or for the joint benefit of the settlor and the settlor's spouse or common-law partner during their joint lifetimes (i.e., a "joint spousal or common-law partner trust", as newly defined in subsection 248(1)); and
- trusts to which paragraph 104(4)(*a*.4) applies (i.e., a trust to which property was transferred by a taxpayer who is an individual (other

than a trust) in circumstances in which section 73 or subsection 107.4(3) applied, where the transfer does not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)).

The restrictions for *alter ego* trusts and trusts to which paragraph 104(4)(*a*.4) applies apply until the death of the settlor. The restrictions for joint spousal or common-law partner trusts apply until the later of the death of the settlor and the death of the spouse or common-law partner. For further detail on new rules for these specified trusts, see the commentary on amended subsections 73(1) and 104(4). The amendment applies to the 2000 and subsequent taxation years.

Clauses 104(6)(*b*)(ii)(A) and (B) are amended to refer to a post-1971 spousal or common-law partner trust, as a consequence of the new definition of this term contained in subsection 248(1) of the Act. For further detail, see the commentary on amended subsection 248(1). This amendment applies to the 2000 and subsequent taxation years.

Subparagraph 104(6)(*b*)(iii) is amended to extend the restrictions for deductions under subsection 104(6) in the taxation year in which the relevant beneficiary dies. The intended effect of the new restrictions is that post-1971 spousal or common-law partner trusts, *alter ego* trusts, joint spousal or common-law partner trusts and trusts to which paragraph 104(4)(*a*.4) applies cannot deduct an amount under subsection 104(6) in respect of income accrued up to the end of the deemed disposition day caused by the death of the spouse, common-law partner or other relevant beneficiary. This amendment applies to the 2000 and subsequent taxation years.

These amendments also reflect changes effected by the *Modernization of Benefits and Obligations Act*.

***Example***

*The spouse beneficiary of a post-1971 spousal or common-law partner trust dies in the 2001 taxation year of the trust. Before distribution to beneficiaries, the trust's total income for the year (determined without reference to any deemed disposition under* *subsection 104(4) and any deduction under subsection 104(6)) is $100, of which $20 is payable to the spouse prior to the spouse's death and of which the remaining $80 is payable to the surviving beneficiaries. $40 of the $100 income accrued before the spouse's death.*

*Results:*

*1. Under subparagraph 104(6)(b)(i) the trust's income for the year that became payable in the year to beneficiaries is $100.*

*2. The amount determined under subparagraph 104(6)(b)(iii) is $20 (i.e., [$100 - ($20 + $60)]).*

*3. The total amount deductible by the trust cannot exceed the amount by which the amount determined under subparagraph 104(6)(b)(i) exceeds the amount determined under subparagraph 104(6)(b)(iii).*

*4. Consequently, the trust's maximum deduction for the year is $80 (i.e., $100 - $20). The trust is not allowed a deduction in respect of the $20 portion of trust income accrued to the end of the deemed disposition day caused by the spouse's death but payable only after the death.*

ITA
104(13)

Subsection 104(13) of the Act sets out amounts included in computing the income of a beneficiary under a trust. Where a trust is not resident in Canada, paragraph 104(13)(*c*) provides that the beneficiary must include in computing income all amounts payable in respect of the beneficiary's interest in the trust, otherwise than as proceeds of disposition or amounts paid in satisfaction of the distribution of capital by a personal trust. There is uncertainty in this regard under the existing law, given that different types of distributions from a trust to a beneficiary might arguably be viewed as resulting in proceeds of disposition with respect to all or part of a beneficiary's interest in the trust.

Subsection 104(13) is amended so that it requires a beneficiary to include in income under that subsection only current income payable from a non-resident trust. For this purpose, a non-resident trust's income is intended to be determined in accordance with Canadian income tax rules. See also, in this regard, the commentary on new section 250.1.

This amendment applies to the 2000 and subsequent taxation years.

ITA
104(15)

Subsection 104(14) of the Act provides a mechanism under which a preferred beneficiary of a trust and the trust can elect to have a designated amount taxed in the hands of the beneficiary rather than at the trust level. Under the definition "preferred beneficiary" in subsection 108(1), a preferred beneficiary of a trust is generally a disabled person resident in Canada who is, or is closely related to, the settlor of the trust. Under paragraph 104(15)(*a*), if the preferred beneficiary is the living spouse or common-law partner beneficiary under a trust for the benefit of a spouse or common-law partner, an "allocable amount" in respect of the beneficiary for a taxation year is the trust's "accumulating income" for the year (which, in general terms, is defined in subsection 108(1) as undistributed trust income).

Subsection 104(15) is amended so that the preferred beneficiary election in connection with allocations of income from an *alter ego* trust, a joint spousal or common-law partner trust, a post-1971 spousal or common-law partner trust or a trust described in the definition "pre-1972 spousal trust" in subsection 108(1) is available to the spouse, common-law partner or other beneficiary (i.e., the settlor) identified in paragraph 104(4)(*a*), only while the spouse, common-law partner or other beneficiary is alive.

This amendment applies to the 2000 and subsequent taxation years.

This amendment also reflects changes effected by the *Modernization of Benefits and Obligations Act*.

ITA
104(19)

Subsection 104(19) of the Act permits a trust to designate dividends received by it in a taxation year on shares of a taxable Canadian corporation to be taxable dividends received by a beneficiary of the trust, rather than by the trust itself, in the year from the corporation.

Subsection 104(19) of the Act is amended so that a trust will, except for the purposes of the dividend gross-up in paragraph 82(1)(*b*) and stop-loss rules in paragraphs 107(1)(*c*) and (*d*) and section 112 of the Act, still be treated as having received the dividend even if it is designated in favour of a beneficiary. In most cases, the trust will be allowed a corresponding deduction under subsection 104(6) to offset the resulting income inclusion. However, as described in the commentary on amendments to subsection 104(6), there are certain restrictions under amended subsection 104(6) on the deduction of amounts made payable from *alter ego* trusts, joint spousal or common-law partner trusts and post-1971 spousal or common-law partner trusts.

This amendment applies to taxation years that end after 2000.

## Beneficiaries' Taxable Capital Gain

ITA
104(21.2)

Subsection 104(21.2) of the Act sets out the rules for allocating the net taxable capital gains of a personal trust to its beneficiaries for the purpose of section 110.6 of the Act. Subsection 104(21.2) is amended to provide that such designations can also be made by a trust described in subsection 7(2) of the Act. In general, subsection 7(2) describes trusts in which the trustee holds shares in trust for an employee and the employee is treated for the purposes of paragraphs 110(1)(*d*) and (*d*.1) of the Act as having acquired and disposed of the shares at the time that the trust acquired and disposed of them. This amendment ensures that a trust described in subsection 7(2) will be able to designate its net taxable capital gains arising from a disposition of "qualified farm property" or "qualified small business corporation shares" to its beneficiaries. New subsection 104(21.2) of the Act applies to trust taxation years that begin after February 22, 1994.

**Deemed gains**

ITA
104(21.4)

New subsection 104(21.4) of the Act provides a special rule that applies where a trust designates, for its taxation year that includes either February 28, 2000 or October 17, 2000, an amount in respect of a beneficiary (the allocated gain) that is deemed because of subsection 104(21) to be a taxable capital gain of the beneficiary for the taxation year of the beneficiary in which the trust's year ends. Subsection 104(21.4) provides that

- the beneficiary is deemed to have a capital gain (deemed gain) equal to the amount if any by which

  (a) the amount determined when the allocated gain is divided by the fraction in amended paragraph 38(*a*) that applies to the trust for the year

  exceeds

  (b) the amount claimed by the beneficiary, not exceeding the beneficiary's exempt capital gain balance for the year in respect of the trust, and

- notwithstanding subsection 104(21), the allocated gain is not included in the income of the beneficiary otherwise than because of the application of this subsection.

The trust is required to disclose to the beneficiary the portion of the deemed gain that is paid out of gains of the trust for each of the pre-February 28, 2000 period, the period that begins at the beginning of February 28, 2000 and ends at the end of October 17, 2000 and the period that begins after October 17, 2000. Where the trust does not disclose that information to the beneficiary, the gains are deemed to be pre-February 28, 2000 gains. Where the trust elects, it can treat its gains as having been realized equally over the number of days in its taxation year, so that the gains in each of the periods will be equal to that proportion of the deemed gains that the number of days in the year of the trust that are in each period is of the number of days in the year. This subsection applies to taxation years that end after February 27, 2000.

ITA
104(21.5)

New subsection 104(21.5) of the Act provides a special rule that applies where no amount is designated in respect of a beneficiary by a trust under subsection 104(21) in respect of its net capital gains or net capital losses for a taxation year of the trust that includes either February 28, 2000 or October 17, 2000.

Where the trust elects, it can treat its net capital gains or net capital losses as having been realized equally over the number of days in its taxation year, so that the net capital gains and losses in each of the periods will be equal to that proportion of the net capital gains and losses described in the commentary on new subsection 104(21.4) that the number of days in the year of the trust that are in each period is of the number of days in the year. This election will permit a trust to treat its net capital gains and losses as having been realized equally throughout the year for the purpose of calculating its capital gains inclusion rate for the year.

For the purpose of this new subsection, net capital gains of a trust is defined as the amount, if any, by which the trust's capital gains from dispositions of property in the year exceeds the trust's capital losses from dispositions of property in the year. Net capital losses of a trust is defined as the amount, if any, by which the trust's capital losses from dispositions of property in the year exceeds the trust's capital gains from dispositions of property in the year.

Personal trusts will be limited to prorating gains to periods in which net taxable capital gains of the trust are realized. For more information see the commentary on subsection 104(21.4) and paragraph 38(*a*).

This amendment applies to taxation years that end after February 27, 2000.

ITA
104(21.6)

New subsection 104(21.6) of the Act, which is applicable for taxation years that end after February 27, 2000, is consequential on the change to the inclusion rate for capital gains. This new subsection applies to a taxpayer who has a taxation year that begins after October 17, 2000 and who is deemed by subsection (21.4) to have deemed capital gains from the disposition of capital property in the year in respect of dispositions of property by a trust of which the taxpayer is a beneficiary.

This new subsection ensures that the inclusion rate for capital gains realized on property disposed of by a trust prior to February 27, 2000 is 3/4 and property disposed of by a trust after February 27, 2000 and before October 18, 2000 is 2/3.

Where the deemed gains are in respect of capital gains from dispositions of property by the trust that occurred before February 28, 2000, 3/2 of those deemed gains are deemed to be capital gains of the taxpayer from the disposition of capital property in the particular taxation year.

Where the deemed gains are in respect of capital gains from dispositions of property by the trust that occurred after February 27, 2000 and before October 18, 2000, 4/3 of those deemed gains are deemed to be capital gains of the taxpayer from the disposition of capital property in the particular taxation year.

In any other case, the deemed gains are deemed to be capital gains of the taxpayer from the disposition of capital property in the particular taxation year.

## Clause 79

### Income Interest in a Trust

ITA
106

Section 106 of the Act provides Rules in respect of an income interest in a trust.

### Cost of Income Interest in a Trust

ITA
106(1.1)

Subsection 106(1.1) of the Act provides that, for the purposes of determining the deduction available under subsection 106(1) in respect of a beneficiary's income interest in a trust, the cost to the beneficiary of the interest is nil except where the interest was acquired from a beneficiary under the trust.

Subsection 106(1.1) is amended so that the deemed nil cost also does not apply to a beneficiary's income interest in a trust where:

- any part of the interest was acquired from a person who was the beneficiary in respect of the interest immediately before that acquisition, or

- the cost of any part of the interest was ever determined not to be nil under the taxpayer migration rules in section 128.1.

Subsection 106(1.1) is also amended to ensure that it applies for the purposes of the Act, and not simply subsection 106(1).

These amendments apply to the 2000 and subsequent taxation years.

### Disposition by Taxpayer of Income Interest

ITA
106(2)

Subsection 106(2) of the Act applies where a taxpayer disposes of an income interest (as defined in subsection 108(1)) in a trust. Paragraph 106(2)(*a*) provides that unless the disposition results from a distribution of property by the trust, the taxpayer's proceeds of disposition are included in computing the taxpayer's income for the year that includes the disposition.

Paragraph 106(2)(*a*) is amended to ensure that where a taxpayer disposes of an income interest in a trust that includes a right to enforce payment by the trust, the proceeds of disposition of the income interest are offset by the amount that has been included in the taxpayer's income under subsection 104(13) because of that right. This measure is meant to ensure that there is no double taxation where such rights are disposed of.

This amendment applies to the 2000 and subsequent taxation years.

## Clause 80

### Interests in Trusts

ITA
107

Section 107 of the Act provides certain rules relating to the acquisition and disposition of interests in, and the property of, trusts.

### Capital Interest in a Trust

ITA
107(1)(*a*) and (*b*)

Subsection 107(1) of the Act contains special rules that apply to the disposition of a capital interest in a trust.

Paragraph 107(1)(*a*) applies for the purpose of computing a taxpayer's taxable capital gain from the disposition of a capital interest in a personal trust (or a prescribed trust described in section 4800.1 of the *Income Tax Regulations*), except where the interest was an interest in a non-resident *inter vivos* trust purchased by the taxpayer and the disposition was not by way of a distribution to which subsection 107(2) applies. For this purpose the residency of the trust is to be determined without reference to section 94 as it read before 2001.

Where paragraph 107(1)(*a*) applies, the adjusted cost base (ACB) to the taxpayer of a trust capital interest for capital gains purposes is generally equal to the greater of the ACB otherwise determined and the "cost amount" of the interest. Subsection 108(1) provides that, for this purpose, the "cost amount" of a capital interest at any time is based on the amount of the trust's money and the cost amount of the trust's other property. The "cost amount" mechanism in paragraph 107(1)(*a*) generally allows the flow-out from a personal or prescribed trust to a beneficiary of trust capital without adverse tax consequences. However, the concluding words in subsection 107(1) provide that paragraph 107(1)(*a*) generally does not apply with regard to certain purchased interests in non-resident trusts.

Paragraph 107(1)(*a*) is amended, in conjunction with the repeal of the concluding wording in subsection 107(1), to ensure that paragraph 107(1)(*a*) never applies to dispositions of any capital interests in non-resident trusts acquired for consideration. New paragraph 108(6)(*c*) and new subsection 108(7) of the Act are relevant in determining where an interest in a trust has been acquired for consideration. Amended paragraph 107(1)(*a*) also provides that, for this purpose, a non-resident trust includes a trust deemed by subparagraph 94(1)(*c*)(i) of the Act to be resident in Canada.

Paragraph 107(1)(*b*) is repealed because it is unnecessary. Since paragraph 107(1)(*a*) applies only for the purposes of computing a taxpayer's capital gain, it is clear without paragraph 107(1)(*b*) that the ACB calculation in paragraph 107(1)(*a*) is not relevant for the purposes of computing a taxpayer's allowable capital loss.

These amendments apply to the 2000 and subsequent taxation years.

## Cost of Capital in a Trust

ITA
107(1.1)

Subsection 107(1.1) of the Act provides, for the purposes of subsection 107(1), that the cost of a capital interest in a trust is nil except where the interest is acquired from a previous capital beneficiary in the trust or where the interest is issued to the beneficiary for consideration equal to the fair market value of the interest at the time of issuance.

Subsection 107(1.1) is amended so that it applies only to trusts that are personal trusts or prescribed trusts. It is intended that trusts described in section 4800.1 of the *Income Tax Regulations* be prescribed for this purpose.

Paragraph 107(1.1)(*b*) is amended to provide that the cost of the interest will not be deemed nil where:

- the cost of any part of the interest would otherwise be determined not to be nil under the taxpayer migration rules in section 128.1 or former section 48 or under paragraph 111(4)(*e*) (acquisition of control), or

- any part of the interest was acquired from a person who was the beneficiary in respect of the interest immediately before that acquisition.

Subsection 107(1.1) is also amended to ensure that it applies for the purposes of the Act, and not simply subsection 107(1).

These amendments apply to the 2000 and subsequent taxation years.

## Distribution by Personal Trust or Prescribed Trust

ITA
107(2), (2.001) and (2.002)

Subsection 107(2) of the Act applies where a personal trust or a trust described in section 4800.1 of the *Income Tax Regulations* distributes property to a beneficiary in satisfaction of all or part of the beneficiary's capital interest in the trust. Under paragraphs 107(2)(*a*) and (*b*), the trust is deemed to have disposed of the property for proceeds of disposition equal to the property's cost amount and the property is deemed to have been acquired by the beneficiary for the same amount plus a "bump" equal to the specified percentage of any excess of the adjusted cost base to the beneficiary of the capital interest over its "cost amount" (as defined by subsection 108(1)) to the beneficiary of the interest. Under paragraph 107(2)(*c*), the beneficiary is deemed to have disposed of the capital interest for proceeds equal to the deemed acquisition cost (determined as if the specified percentage referred to above were 100 per cent) less a reduction equal to the amount of debt assumed by the beneficiary that is conditional upon the distribution of the property. Under subsection 107(3), the specified percentage is 100 per cent in the case of non-depreciable capital property (e.g., land and shares) and 50 per cent in any other case.

Paragraph 107(2)(*f*) is intended to prevent, where the property distributed by a trust is eligible capital property, an overstatement of the income inclusions under subparagraph 14(1)(*a*)(v) or paragraph 14(1)(*b*) of the Act on the subsequent disposition of eligible capital property by the beneficiary.

Subsection 107(2) is amended to clarify that it applies in connection with distributions in respect of a capital interest in a personal or prescribed trust only if the distribution results in a disposition of all or part of the capital interest. Where the distribution does not constitute a disposition of a capital interest in a trust because of new paragraph (*i*) of the definition "disposition" in subsection 248(1), the rules in amended subsection 107(2.1) apply.

Subsection 107(2) is amended so that it is expressly subject to amended subsections 107(4) to (5). This amendment is made for technical clarity and does not represent any change in policy. Amended subsections 107(4) to (5) describe trust distributions to which subsection 107(2.1) is to apply.

Subsection 107(2) is also amended so that it is subject to new subsections 107(2.001) and (2.002). New subsection 107(2.001) allows a trust to elect out of the rules in subsection 107(2) in respect of a distribution of property to a beneficiary in satisfaction of the beneficiary's capital interest in the trust where

- the trust is resident in Canada at the time of the distribution,
- the property is taxable Canadian property, or
- the property is capital property used in, eligible capital property in respect of, or property described in the inventory of, a business carried on by the trust through a permanent establishment (as defined by regulation) in Canada immediately before the time of the distribution.

If this election is made, the distribution is subject to the rules in amended subsection 107(2.1). An electing trust is generally required to file a prescribed form with the Minister with its tax return for the taxation year that includes the time of the distribution. This amendment applies to distributions made after October 1, 1996. For distributions made before the date of Royal Assent, the election is considered to have been made on a timely basis if it is filed by the filing-due date for the trust's taxation year that includes the date of Royal Assent.

New subsection 107(2.002) applies where a non-resident trust makes a distribution, after 1999, of a property (other than taxable Canadian property or business property connected with a Canadian permanent establishment) to a beneficiary of the trust in satisfaction of the beneficiary's capital interest in the trust. The beneficiary in these circumstances may elect out of the rules in subsection 107(2) in respect of the distribution, with the result that subsection 107(2.1) applies in respect of the distribution. The election is made by filing a prescribed form with the beneficiary's income tax return. Where the election is made, the cost amount of the beneficiary's interest also is deemed to be nil for the purposes of subparagraph 107(1)(*a*)(ii). This amendment applies to distributions made after 1999. For distributions made before the date of Royal Assent, the election is considered to have been made on a timely basis if it is filed by the filing-due date for the beneficiary's taxation year that includes the date of Royal Assent.

Paragraph 107(2)(*b*.1) is introduced (in conjunction with consequential amendments to paragraphs 107(2)(*b*) and (*c*) and the repeal of subsection 107(3)) so that the specified percentages referred to above are explicitly provided under subsection 107(2). This amendment is intended to clarify the operation of subsection 107(2).

In addition, the specified percentage for property (other than non-depreciable capital property and eligible capital property) is being increased from 50 per cent to 75 per cent. The specified percentage for eligible capital property is increased from 50 per cent to 100 per cent in recognition that only a maximum of 75 per cent of the cost of eligible capital property can ultimately be deducted for income tax purposes. This amendment is intended to reduce the differential in the tax treatment of depreciable and non-depreciable property in this context, so that this differential corresponds more closely to that which prevailed before the increase in the capital gains inclusion rate from 50 per cent to 75 per cent.

Paragraph 107(2)(*c*) is amended so that the reduction, because of debt assumed by the beneficiary, to a beneficiary's proceeds of disposition of the beneficiary's capital interest is now provided under the new definition "eligible offset" in subsection 108(1).

Paragraph 107(2)(*d*.1) is amended to clarify the tax consequences of the disposition of taxable Canadian property by a trust to non-resident beneficiaries before October 2, 1996. In the event that the property was explicitly deemed to have been taxable Canadian property under a number of specified provisions of the Act, paragraph 107(2)(*d*.1) ensures that it continues to be taxable Canadian property of the beneficiary. This amendment applies in determining after October 1, 1996 whether property is taxable Canadian property.

Except as indicated above, these amendments apply to distributions made after 1999.

Paragraph 107(2)(*f*) is amended consequential to the re-numbering of subsection 14(1), which is described in further detail in the commentary to that subsection. This amendment applies to taxation years that end after February 27, 2000.

ITA
107(2.01)

Subsection 107(2.01) of the Act allows a personal trust to elect to be treated as if it had disposed of, and reacquired, a principal residence at its fair market value immediately before distributing the property to one of its beneficiaries under subsection 107(2). The rule does not apply to distributions of property by a post-1971 spousal or common-law partner trust in circumstances to which subsection 107(4) applies. (Subsection 107(4) generally applies to distributions made by such a trust to a beneficiary, other than the beneficiary spouse or common-law partner, before the death of the beneficiary spouse or common-law partner.) Subsection 107(2.01) is designed to allow a personal trust to take advantage of the principal residence exemption. In this regard, reference can be made to the definition of "principal residence" in section 54.

Subsection 107(2.01) is amended to eliminate the reference to subsection 107(4), given that subsection 107(2.1) now applies to distributions to which amended subsection 107(4) applies.

This amendment applies to distributions made after 1999.

ITA
107(2.1)

Where trust property is distributed by a trust to a beneficiary in satisfaction of the beneficiary's capital interest in the trust and subsection 107(2) of Act does not apply, the rules in subsection 107(2.1) apply. Subsection 107(2.1) also applies to a distribution by a trust in satisfaction of a right described in subsection 52(6). Under paragraphs 107(2.1)(*a*) to (*c*), the trust is deemed to have disposed of the distributed property for the property's fair market value and the beneficiary is deemed to have acquired the property, and disposed of the capital interest or right described in subsection 52(6), for the same amount. Notwithstanding the reference to subsection 52(6) (under which a cost is ascribed to the right to enforce payment out of a trust's capital gains and income), it is unclear that there is relief from double taxation on gains associated with the dispositions of the distributed property and the relinquished capital interest.

Subsection 107(2.1) is amended so that it no longer overrides every other provision of the Act. For example, subsection 107(2.1) no longer deems there to be a disposition of property where the existing law provides that there was no disposition because of paragraph (*e*) of the definition "disposition" in section 54. This amendment is consequential to the replacement of the existing definition "disposition" in section 54 with the new definition of the same expression in subsection 248(1) and new rules in section 107.4 to deal with acquisitions by trusts that do not involve any change in beneficial ownership.

Subsection 107(2.1) is amended so that it applies in connection with all distributions in respect of a capital interest in a trust, regardless of whether the distribution results in a disposition of all or part of the capital interest. This includes rights to which subsection 52(6) formerly applied, but which are now included as part of a capital interest in a trust under the amended definition of "capital interest" in subsection 108(1). Distributions in respect of amounts described in paragraph (*h*) and (*i*) of the definition "disposition" in subsection 248(1) need to be referred to in order to take into account the possibility that a distribution from a trust may consist only partly in respect of such amounts. In addition, even if a cash distribution is solely in respect of such an amount, it may not necessarily be denominated in Canadian dollars, in which case the trust may recognize a foreign currency gain or loss on the distribution. However, under amended paragraph 107(2.1)(*c*), proceeds of disposition are only determined with regard to the portion of a capital interest in a trust that is disposed of because of a distribution from the trust. No proceeds of disposition are determined in respect of rights to amounts to which paragraph (*h*) and (*i*) of that definition apply.

The proceeds of disposition for the portion of a capital interest in a trust that is disposed of because of a distribution (other than a distribution to which paragraph 107(2.1)(*d*) applies) are determined under paragraph 107(2.1)(*c*) as follows:

- ADD the proceeds of disposition determined in respect of the distribution (other than any portion of those proceeds that is a payment to which paragraph (*h*) or (*i*) of the definition "disposition" in subsection 248(1) applies). Note: paragraph (*h*) or (*i*) of that definition apply to a payment that represents a distribution of income or capital gains or to a payment from a unit trust that does not cause a reduction of the number of issued units of the trust;

- where the property distributed is not Canadian resource property or foreign resource property, SUBTRACT the amount (if any) by which the fair market value of the property exceeds the cost amount of the property (however, disregard this excess to the extent it represents a payment to which paragraph (*h*) or (*i*) of that definition applies); and

- SUBTRACT the "eligible offset" in respect of the distribution, as defined in subsection 108(1). (This is essentially debt assumed by the beneficiary on the distribution.)

Where there is no disposition of a capital interest because of paragraph (*h*) or (*i*) of the definition "disposition" in subsection 248(1), an amount distributed from the trust to a beneficiary generally results in a reduction of the beneficiary's adjusted cost base of the capital interest pursuant to paragraph 53(2)(*h*).

Paragraph 107(2.1)(*d*) applies to distributions of property (other than taxable Canadian property or business property connected to a Canadian permanent establishment) from a non-resident trust unless subsection 75(2) would, if the Act were read without reference to that paragraph, result in the attribution to a taxpayer of an income, loss, taxable capital gain or allowable capital loss in respect of the distribution. In these circumstances, new paragraph 107(2.1)(*d*) deems the beneficiary to acquire the property at its fair market value and to dispose of the corresponding portion of the capital interest in the trust for proceeds equal to the fair market value of the property less the total of two amounts. The first amount represents the portion of the distribution that is a payment to which paragraph (*h*) or (*i*) of the definition "disposition" in subsection 248(1) applies (i.e., a payment that represents a distribution of income or capital gains, or a payment from a unit trust that does not cause a reduction of the number of issued units of the trust). The second amount is the "eligible offset" (as defined in subsection 108(1)) in respect of the distribution (i.e., essentially debt assumed by the beneficiary on the distribution). Paragraph 107(2.1)(*d*) also ensures that there are no tax consequences to the trust in respect of the distribution of the property.

Under new subsection 107(2.1), a distribution of property may give rise to a capital gain at the trust level. It is arguable that upon a distribution to a beneficiary from a trust of a property with an accrued capital gain, the capital gain realized by the trust is paid out to the beneficiary. In these circumstances, the taxable portion of the capital gain generally would be included in the income of the beneficiary because of subsection 104(13) of the Act and the trust would receive a corresponding deduction from its income under subsection 104(6).

This result is predicated, in part, on the assumption that a trust can make a designation under subsection 104(21) of the Act in respect of a beneficiary that is not a beneficiary of the trust at the end of the trust's taxation year (i.e. because the distribution of property was in satisfaction of the beneficiary's entire capital interest in the trust). However, the trust indentures of some mutual fund trusts do not accommodate the possibility of making a designation under subsection 104(21) in respect of such beneficiaries. As a transitional measure, therefore, where a mutual fund trust has elected under subsection 107(2.11), new paragraph 107(2.1)(*e*) allows the mutual fund trust to elect for the capital gain to be recognized at the beneficiary level (i.e. as proceeds of disposition of the beneficiary's capital interest).

The result under paragraph 107(2.1)(*e*) would appear, in combination with the results under paragraph 107(2.1)(*a*), to give rise to double taxation, because of the trust's election under subsection 107(2.11). However, under section 132 of the Act, a capital gains refund generally would be available to the trust to offset the gain at the trust level.

These amendments apply to distributions made after 1999 (other than distributions before March 2000 in connection with rights described in subsection 52(6) of the Act that were acquired before 2000).

The examples below illustrate the operation of amended subsection 107(2.1). Except as indicated otherwise, it is assumed that the trusts referred to below are all resident in Canada.

***Example 1***

*In 2001, a commercial trust distributes non-depreciable capital property (shares) to its beneficiary resident in Canada in satisfaction of the beneficiary's capital interest in the trust. The adjusted cost base of the shares is $40. The adjusted cost base of the beneficiary's capital interest is $20. The fair market value of the property is $100.*

*Results:*

*1. Subsection 107(2.1) applies to the distribution.*

*2. The trust is deemed by paragraph 107(2.1)(a) to have disposed of the property for $100 proceeds, so there is a capital gain of $60 on the resulting disposition and a taxable capital gain of $30.*

*3. The beneficiary is deemed by paragraph 107(2.1)(b) to have acquired the property at a $100 cost.*

*4. Because the distribution gives rise to a capital gain at the trust level, the amount of the capital gain ($60) reduces the proceeds of disposition of the beneficiary's capital interest under subparagraph 107(2.1)(c)(ii). The beneficiary is deemed to have disposed of the capital interest for $40 proceeds ($100 - $60). Alternatively, in the event that the payment of the gain were considered to be payment of the capital gains of the trust to which paragraph (i) of the definition "disposition" in subsection 248(1) applied, $40 would be determined under subparagraph 107(2.1)(c)(i) and no amount would be determined under subparagraph 107(2.1)(c)(ii). Consequently, under both of the alternative analyses, the beneficiary's proceeds of disposition of the beneficiary's capital interest in the trust are $40.*

*5. Consequently, the capital gain from the disposition of the capital interest is $20 ($40 - $20).*

*6. If the trust is a mutual fund trust, the distribution occurs in a taxation year of the trust before its 2003 taxation year, the trust has elected under subsection 107(2.11) in respect of the year and the trust so elects under paragraph 107(2.1)(e), the beneficiary's proceeds of disposition of its capital interest are deemed to be equal to the fair market value of the property distributed (i.e, the amount determined under paragraph 107(2.1)(a)). Consequently, the capital gain from the disposition of the capital interest is $80 ($100 - $20). In these circumstances, the capital gains refund mechanism in section 132 of the Act would apply to offset the capital gains realized on the distribution at the trust level.*

***Example 2***

*In 2001, a personal trust distributes non-depreciable capital property (shares that are not taxable Canadian property) to its non-resident beneficiary in satisfaction of the beneficiary's capital interest in the trust. The adjusted cost base of the shares is $40. The adjusted cost base of the beneficiary's capital interest, determined before the application of paragraph 107(1)(a), is $0. The fair market value of the property is $100.*

***Results:***

*1. Subsection 107(2.1) applies to the distribution because of the application of amended subsection 107(5).*

*2. The trust is deemed by paragraph 107(2.1)(a) to have disposed of the property for $100 proceeds, so there is a capital gain of $60 from the resulting disposition and a taxable capital gain of $30.*

*3. The beneficiary is deemed by paragraph 107(2.1)(b) to have acquired the property at a $100 cost.*

*4. Because the distribution gives rise to a capital gain, the amount of the capital gain ($60) reduces the proceeds of the beneficiary's capital interest under subparagraph 107(2.1)(c)(ii). The beneficiary is deemed to have disposed of the capital interest for $40 proceeds ($100 - $60). The alternative analysis in paragraph 4 of Example 1 would likewise result in deemed proceeds of $40.*

*5. The capital interest in the trust constitutes taxable Canadian property for the non-resident beneficiary. For the purposes of computing capital gains, the adjusted cost base of the capital interest under subsection 107(1) is $40, being the greater of its adjusted cost base (nil) determined before the application of that subsection and the cost amount ($40) to the trust of the distributed property. Consequently, the taxable capital gain from the disposition of the capital interest is nil.*

*6. The allowable capital loss from the disposition of the capital interest is also nil.*

ITA
107(2.11)

New subsection 107(2.11) of the Act provides a special rule that, for the purposes of subsections 104(6) and (13), allows income of a trust for a taxation year (computed without reference to subsection 104(6)) to be computed without regard to the tax consequences under subsection 107(2.1) (and former subsection 107(5)) of property distributed in kind to beneficiaries. This ensures that the gains, if any, that might arguably flow-out in some circumstances to beneficiaries as a consequence of the operation of subsections 107(2.1) and (5), will instead be included in income at the trust level.

More specifically, subsection 107(2.11) applies in two cases:

- where a trust resident in Canada distributes property to a non-resident beneficiary after October 1, 1996, the result described above applies in respect of distributions to non-resident beneficiaries if the trust so elects for the taxation year of the distribution or for a taxation year preceding the distribution. The election is considered to have been made on a timely basis if it is filed with the Minister before the trust's filing-due date for its taxation year that includes the date of Royal Assent; and

- where a trust resident in Canada distributes property to a beneficiary after 1999, the result described above also applies in respect of all beneficiaries (including non-resident beneficiaries) if the trust so elects for the taxation year of the distribution or a taxation year that precedes the distribution. The election is considered to have been made on a timely basis if it is filed with the Minister before the trust's filing-due date for its taxation year that includes the date of Royal Assent.

## Flow-Through Entity

ITA
107(2.2)

Subsection 107(2.2) of the Act provides for an addition to the cost base of property received by a taxpayer from a trust in satisfaction of the taxpayer's interest in the trust where the exempt capital gains balance of the taxpayer in respect of the trust has not been fully utilised.

The amendment to subparagraph 107(2.2)(*a*)(ii) replaces the reference to the expression "4/3 of" with a reference to the word "twice" and is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a taxpayer that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" in subparagraph 107(2)(*a*)(ii) is to be read as reference to the fraction that is the reciprocal of the fraction in amended paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Cost of Property

ITA
107(3)

Subsection 107(3) of the Act is repealed. See the commentary above on amendments to subsection 107(2).

## Trust in Favour of Self, Spouse or Common-Law Partner

ITA
107(4)

Subsection 107(4) of the Act applies where a post-1971 spousal or common-law partner trust distributes capital property, resource property or land to a beneficiary other than the beneficiary spouse or common-law partner. When this occurs while the beneficiary spouse or common-law partner is alive, there is generally a deemed disposition of the property at its fair market value.

Subsection 107(4) is amended so that similar rules apply to *alter ego* trusts and joint spousal or common-law partner trusts, as newly defined in subsection 248(1). Subsection 107(4) will apply to a distribution by these trusts where the individual (or, in the case of a joint spousal or common-law partner trust, either the individual or the spouse or common-law partner) is alive on the day of the distribution and the distribution is made to a beneficiary other than the individual (or, in the case of a joint spousal or common-law partner trust, the individual or the spouse or common-law partner). For more detail on these trusts, see the commentary on amended subsections 73(1) and 104(4).

Subsection 107(4) is amended so that the rules set out in amended subsection 107(2.1) apply to distributions covered by subsection 107(4).

These amendments apply to distributions made after 1999.

These amendments also reflect changes effected by the *Modernization of Benefits and Obligations Act.*

ITA
107(4.1)

Subsection 107(4.1) of the Act applies in certain cases where a reversionary trust distributes property to a specified beneficiary under the trust. When this occurs, there is a deemed disposition of the property at its fair market value.

Subsection 107(4.1) is amended so that, for distributions after 1999 in these cases, the rules set out in amended subsection 107(2.1) apply.

Subsection 107(4.1) is also amended so that the existing rule that provides for a deemed disposition of a property at its fair market value generally will apply to a distribution made after Announcement Date of a particular property by a particular trust that is not a reversionary trust where:

- a trust that is a reversionary trust at a particular time has transferred property to the particular trust through one or more dispositions to which subsection 107.4(3) applied, and

- the particular property was not, at any time after the particular time and before the distribution, the subject of a disposition for proceeds of disposition equal to the fair market value of the property at the time of the disposition.

ITA
107(5)

Subsection 107(5) of the Act applies to the distribution of property (other than taxable Canadian property, Canadian resource property and shares in non-resident-owned investment corporations), where the distribution would otherwise be made to a non-resident beneficiary on a rollover basis under subsection 107(2). With regard to such distributions, subsection 107(5) provides for a deemed disposition of the distributed property at its fair market value and an acquisition by the beneficiary for the same amount. In addition, paragraph 107(5)(*c*) provides for proceeds of disposition of the relinquished capital interest equal to the adjusted cost base of that interest.

Subsection 107(5) is amended to replace existing exemptions with regard to taxable Canadian property and Canadian resource property with exemptions for property described in any of new subparagraphs 128.1(4)(*b*)(i) to (iii). This amendment applies to distributions made after October 1, 1996. For further detail on the enumerated subparagraphs, see the commentary on amended subsection 128.1(4).

Subsection 107(5) is also amended so that it only applies with regard to distributions by trusts resident in Canada. This amendment applies to distributions made after October 1, 1996 and recognizes that, if a distribution of property is made from a non-resident trust to a non-resident beneficiary, Canada's authority to ultimately collect tax on a future disposition of the property has not been compromised because of the distribution. This amendment is consistent with the policy with regard to distributions before October 2, 1996, as the type of property deemed to be disposed of before that date under subsection 107(5) would not have resulted in a non-resident trust being subject to Canadian tax.

Subsection 107(5) is amended so that, where it applies, the amended rules in subsection 107(2.1) provide for the corresponding tax consequences. This amendment applies with regard to distributions made after 1999.

ITA
107(5.1)

Subsection 107(5.1) of the Act is a special rule that applies for the purposes of computing instalment interest. The rule applies where

- there has been one or more distributions after October 1, 1996 of taxable Canadian property by a trust resident in Canada in a taxation year to non-resident beneficiaries, and
- paragraphs 107(2)(*a*) to (*c*) do not apply to such distributions solely because of subsection 107(5).

For the purposes of the measures pertaining to tax instalments or instalment interest in sections 155, and 156, subsections 156.1(1) to (3) and subsections 161(2), (4) and (4.01), the trust's total taxes under Part I and Part I.1 are deemed in these circumstances to be the lesser of two amounts. The first amount is the trust's total taxes payable under those Parts for the distribution year, determined without taking into consideration the carryback of losses and other consequences described in the definition "specified future tax consequence" in subsection 248(1). The second amount is computed in the same manner, except that it is assumed that subsection 107(5) does not apply to each distribution of trust property in the distribution year that is described above. The general effect of subsection 107(5.1) is to ignore a trust's income tax liabilities arising from the distribution of taxable Canadian property to a non-resident beneficiary for the purpose of computing the trust's instalment interest obligations.

Subsection 107(5.1) is similar to new subsection 128.1(5). Both of these subsections should be read in conjunction with new subsections 220(4.5) and (4.6), under which the posting of security can result in a deferral of the accrual of arrears interest on unpaid taxes.

This amendment applies to distributions made after October 1, 1996.

## Clause 81

### Distribution by Employee Trust, etc.

ITA
107.1

Section 107.1 of the Act provides rules to deal with a distribution to a taxpayer of a property by an employee trust or a trust governed by an employee benefit plan under which the taxpayer is a beneficiary. In the case of an employee trust, paragraph 107.1(*a*) requires the trust to recognize a gain or loss when it distributes trust property to a beneficiary by treating the trust as having disposed of the property at its fair market value immediately before the time of distribution. That paragraph also ensures that the beneficiary is considered to acquire the property at that fair market value.

Section 107.1 is amended so that paragraph 107.1(*a*) applies to a trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1). This is intended to ensure that, in the unusual circumstance that property other than cash is distributed by the trust, there is a recognition in the trust of any gain or loss in respect of the property. For more on new paragraph (*a*.1) of the definition "trust" in subsection 108(1), see the commentary on that subsection.

This amendment applies to the 1999 and subsequent taxation years.

## Clause 82

### Qualifying Disposition

ITA
107.4(1) to (3)

Subsection 107.4(3) of the Act applies where there has been a "qualifying disposition" of property. As set out in subsection 107.4(1), a qualifying disposition of property is a disposition that does not result in any change in the beneficial ownership of the property and that otherwise meets the conditions set out in that subsection. Subsection 107.4(3) generally provides for a rollover where a property is transferred by way of a qualifying disposition.

The commentary below summarizes the tax consequences of transfers to bare trusts, protective trusts and revocable living trusts under the existing law. Reference should also be made to the commentary on amended section 73, subsection 104(1) and the definition "disposition" in subsection 248(1).

### *Bare Trusts*

The stated interpretation of the existing law by the Canada Customs and Revenue Agency (CCRA) is that, where property is held by a bare trust, the trust is ignored for income tax purposes and the transferor/settlor is considered to be the owner of property held by the trustee in the trustee's capacity as an agent. Paragraph (*e*) of the definition "disposition" in section 54 is the current authority for the position that there is no "disposition" of property on its transfer to a "bare trust".

The CCRA has stated that it generally views a trust to be a bare trust when:

- the trustee has no significant powers or responsibilities, and can take no action without instructions from the settlor;
- the trustee's only function is to hold legal title to the property; and
- the settlor is the sole beneficiary and can cause the property to revert to him or her at any time.

The CCRA's position that transfers to what it views as bare trusts do not constitute dispositions has generally been reinforced because, under amended subsection 104(1), a trust generally is deemed not to include an arrangement under which the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust's property. See also the commentary on new subsection 104(1) and the definition "disposition" in subsection 248(1).

### *Revocable living trusts*

The CCRA has expressed the view that a "revocable living trust" should be fully recognized as a trust for income tax purposes. It is of the view that the transfer of property to such a trust involves a change in beneficial ownership of the property and is at the full fair market value of the property. A "revocable living trust" is an estate planning tool used, instead of a will, by individuals. The settlor of the trust is the trustee and, during his or her lifetime, is the sole income and capital beneficiary and retains the right to revoke, alter or amend the trust at any time. However, there is a change of beneficial ownership involved in a transfer to a "revocable living trust" because other beneficiaries under the trust have rights under the trust in the event that the settlor does not revoke the trust before his or her death.

Section 107.4 is generally consistent with the CCRA's present views in this regard. New subsection 107.4(3) is not intended to apply to transfers to revocable living trusts, on the basis that there is no qualifying disposition of property involved. However, for trusts created after 1999, it is generally possible for individuals who are at least 65 years of age to transfer capital property to a revocable living trust on a rollover basis pursuant to amended subsection 73(1).

### *Protective trusts*

The CCRA considers the attributes of a "protective trust" to be as follows:

- The settlor is the sole beneficiary under the trust.

- The settlor is entitled to as much of the annual income and realized capital gains of the trust as he or she requests.

- The property of the trust will revert to the settlor if the trust is terminated prior to the settlor's death.

- The trust will terminate upon the death of the settlor unless it is terminated at an earlier date. (When the settlor dies, any property held by the trust will devolve in accordance with the terms of the settlor's will or, if the settlor dies intestate, the property of the trust will devolve in accordance with the laws of intestacy that are relevant to the estate.)

The CCRA considers that, under the existing law, a protective trust is fully recognized as a trust for income tax purposes and that there is no "disposition" of property where a settlor transfers it to a protective trust. Trust income and gains are attributed to the settlor in accordance with subsection 75(2).

New subsection 107.4(3) will apply to transfers after December 23, 1998 to protective trusts, assuming that the requirements for a qualifying disposition are met. However, transfers of capital property to protective trusts created after 1999 will generally be covered by amended subsection 73(1).

The rules in subsection 107.4(3) (and subsection 73(1), where it is applicable) also bridge a gap in the existing law in the context of protective trusts by making it clear at what cost a transferee is considered to acquire property where there has been a transfer of property without any change in its beneficial ownership and the bare trust regime does not apply.

*New subsections 107.4(1) to (3)*

As discussed above, subsection 107.4(3) generally provides a rollover whenever there is a qualifying disposition of property to a trust. Under new subsection 107.4(1), a "qualifying disposition" of property is a "disposition" (as defined in subsection 248(1)) of the property as a result of a transfer to a particular trust where

- because of the disposition, there is no change in the beneficial ownership of the property,

- the proceeds would not, disregarding sections 69 and 73, be determined under any other provision of the Act (e.g., transfers from a trust to a beneficiary under the trust where the proceeds are determined under subsection 107(2)),

- the disposition is neither by a person resident in Canada to a non-resident trust nor a transfer of taxable Canadian property from a non-resident person who was resident in Canada in any of the 10 calendar years preceding the transfer to a non-resident trust,

- the disposition is not by a partnership (other than a partnership each member of which is non-resident) to a non-resident trust,

- the disposition is not by a partnership, if the disposition is part of a series of transactions or events beginning after December 17, 1999 that includes the cessation of the partnership's existence and a subsequent distribution from a personal trust to a former member of the partnership in circumstances to which subsection 107(2) applies,

- immediately after the disposition, unless the contributor is a trust, there is no absolute or contingent right as a beneficiary under the particular trust for any beneficiary other than the contributor or joint contributors, as the case may be. (For this purpose, there is a restricted meaning under new subsection 104(1.1) associated with the expression "beneficiary".),

- the disposition does not occur after December 17, 1999 if the disposition is, or is part of, a transaction where the contributor receives for the disposition any consideration (other than consideration that is an interest of the contributor as a beneficiary under the particular trust or the assumption by the particular trust of debt for which the property may at the time of the disposition reasonably be considered to be security),

- the disposition is not to a trust described in any of paragraphs (*a*) to (*e*.1) of the definition "trust" in subsection 108(1) (generally trusts relating to employee compensation and retirement savings and trusts deemed to exist for income tax purposes), except if it is a disposition by a trust so described,

- the disposition is not part of a series of transactions or events

    - that begins after December 17, 1999 and that includes the disposition of any interest in a personal trust (other than a disposition solely as a consequence of a distribution from the trust),

    - that begins after December 17, 1999 and that includes the subsequent acquisition, for consideration given to a personal trust, of any interest in the trust, or

    - that begins after June 5, 2000 and that includes the transfer to the particular trust of particular property as consideration for the acquisition of a capital interest in the particular trust, if the particular property can reasonably be considered to have been received in order to fund a distribution from the trust (other than a distribution that is proceeds of disposition of a capital interest in the particular trust),

- subsection 73(1) would not apply to the disposition if no election were made under that subsection and there were no restrictions in subsection 73(1.02) as to the circumstances in which subsection 73(1) applies, and

- where the contributor is an amateur athlete trust, a cemetery care trust, an employee trust, an *inter vivos* trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization, a related segregated fund trust (as defined in section 138.1), a trust described in paragraph 149(1)(*o*.4) or a trust governed by an eligible funeral arrangement, an employees profit sharing plan, a registered education savings plan or a registered supplementary unemployment benefit plan, the particular trust is the same type of trust. For example, if the contributor is a related segregated fund trust, the particular trust must also be a related segregated fund trust.

Subsection 107.4(2) provides a supplementary rule that applies for the purpose of paragraph 107.4(1)(*a*). Paragraph 107.4(2)(*a*) is designed to allow in certain cases for the division among trusts of a property or group of identical properties where the economic ownership of the properties remains unchanged. In particular, where a trust disposes of a property to another trust, there is deemed to be no change in beneficial ownership of the property if:

- the transferor trust receives no consideration for the disposition, and

- as a consequence of the disposition, the value of each beneficiary's beneficial ownership at the beginning of the period under the transferor trust in each particular property of the transferor trust (or group of two or more properties of the transferor trust that are identical to each other) is the same as the total value of the beneficiary's beneficial ownership at the end of the period under the transferor trust and the other trust or trusts in the particular property (or in property that was immediately before the disposition included in the group of identical properties).

New subsection 107.4(2.1) provides, for the purpose of applying paragraph 107.4(2)(*a*) in respect of a transfer by a transferor trust of property that includes a share and money, that the other trust or trusts referred to in that paragraph may receive, in lieu of a transfer of a fractional interest in a share that would otherwise be required, a disproportionate amount of money or interest in the share (the value of which does not exceed the lesser of $200 and the fair market value of the fractional interest).

***Example***

*Trust A holds the following properties in trust for beneficiaries X and Y:*

*1,000 identical shares of ABC Corp.;*
*50 identical bonds of PQR Corp.;*
*1,009 identical shares of MNO Corp. with a fair market value of $50,450; and*
*$1,000 cash denominated in Canadian dollars.*

*Assume that X has a 30 % beneficial interest in the trust and Y has the remaining 70 % beneficial interest.*

*In a period that does not exceed 1 day, Trust A completes the following transactions:*

- *transfers to Trust B for X: 300 shares of ABC Corp., 15 PQR bonds, 303 shares of MNO Corp. and $285 cash; and*
- *transfers to Trust C for Y: 700 shares of ABC Corp., 35 PQR bonds, 706 shares of MNO Corp. and $715 cash.*

*Trust A received no consideration for the transfers of property.*

*Results:*

1. *There has been no change in the economic interests of X and Y.*

2. *In particular, the values of the respective beneficial ownership of X and Y in each of the two groups of identical properties (i.e., the shares of ABC Corp. and the PQR bonds) has not changed as a consequence of the transfer.*

3. *Because the group of identical properties consisting of the shares of MNO Corp. might have required the issuing of a fractional share, subsection 107.4(2.1) provides that Y's entitlement to a 0.3 fraction of an MNO Corp. share may be substituted by cash of an equivalent fair market value. Because each MNO Corp. share has a fair market value of $50 (so that a 0.3 fractional share interest has a fair market value of $15), the Trust C for Y receives $15 in cash in lieu of the fractional share. Trust B for X receives, in these circumstances, an additional 0.3 fraction of an MNO Corp. share (i.e., it receives 303 shares, rather than 302.7 shares of MNO Corp.) in lieu of $15 cash.*

4. *Paragraph 107.4(2)(a) provides that, in the circumstances described above, the requirement in paragraph 107.4(1)(a) that there be no change in beneficial ownership is satisfied. Assuming the other conditions under subsection 107.4(1) are satisfied, there would be a qualifying disposition of each of the properties transferred as described above from Trust A.*

Paragraph 107.4(2)(*b*) deems there to be no change in beneficial ownership of a property where the property is transferred from a trust governed by an RRSP or RRIF to another trust governed by an RRSP or RRIF, provided that the annuitant of the transferor is the same as that of the transferee. The application of paragraph 107.4(2)(*b*) is illustrated in the following example.

***Example***

*Tom is the annuitant of an RRSP under which Laura is named as the beneficiary. The property is transferred from that RRSP trust to another trust governed by an RRSP under which Tom is the annuitant and under which Michelle is named as beneficiary. Assume that, because of an election or otherwise, neither paragraph (f) nor (g) of the definition "disposition" in subsection 248(1) of the Act applies.*

*Results:*

*1. In these circumstances, paragraph 107.4(2)(b) deems, for the purpose of paragraph 107.4(1)(a), there to be no change in beneficial ownership.*

*2. Consequently, there should be a qualifying disposition of the property.*

Paragraph 107.4(2)(*b*) is part of a set of amendments intended to clarify the tax treatment of transfers of property involving RRSPs and RRIFs. For further detail, see the commentary on paragraph 107.4(3)(*c*), paragraphs (*f*) and (*g*) of the new definition "disposition" (in subsection 248(1)) and subsection 206(4).

Under paragraph 107.4(3)(*a*), the transferor's proceeds from the qualifying disposition are generally deemed to be the cost amount of the property. However, provision is made for the transferor to elect another amount, between the cost amount of the property and its fair market value, as proceeds.

Under paragraph 107.4(3)(*b*), the proceeds determined under paragraph (*a*) are also generally treated as the cost to the transferee trust of the property. However, this amount is reduced in some cases where the fair market value of the property is less than the cost amount. The reduction in these cases is equal to a hypothetical reduction in the transferor's loss on the disposition of the property. This hypothetical reduction is computed, using the stop-loss rules with regard to partnership interests (subsection 100(4)), trust interests (paragraphs 107(1)(*c*) and (*d*)) and shares (subsections 112(3) to (4.2)), on the assumption that the proceeds of disposition are the fair market value of the property rather than its cost amount.

Paragraph 107.4(3)(*b*) does not, however, apply for the purpose of the foreign property limit under Part XI. For this purpose, except for transfers before 2000 between RRSP trusts and RRIF trusts, the cost amount to the transferor under paragraph 107.4(3)(*c*) is the cost to the transferee of the same property unless the transferee elects that the cost be the fair market value of the property at the time of its transfer. (It is expected that this election will be used only if the transferee trust does not have information with regard to the cost amount of property from the transferor trust. If, on the other hand, the election is made for the purpose of avoiding Part XI tax, it is invalid.) With regard to the excepted transfers involving RRSPs and RRIFs, the transferee's cost of the property is its fair market value unless the transferee files the election described in subparagraph 107.4(3)(*c*)(i). (If this election is made for the purpose of avoiding Part XI tax, it is invalid.) For further detail on transfers involving

RRSPs and RRIFs see the commentary, including examples, on paragraph (*g*) of the new definition "disposition" in subsection 248(1).

In addition, where the property is depreciable property or eligible capital property, there are rules in paragraphs 107.4(3)(*d*) and (*e*) designed, for the purposes of the capital cost allowance rules in the Act, to put the transferee in the same position as the transferor in the event that the transferee subsequently disposes of the property. These rules are parallel to existing rules in subsection 107(2) for trust distributions to beneficiaries.

Paragraph 107.4(3)(*f*) provides that, if the property was deemed to be taxable Canadian property of the transferor because of a number of specified provisions in the Act, the property retains that character in the hands of the transferee.

Paragraph 107.4(3)(*g*) provides that, where the transferor is a related segregated fund trust (as defined in section 138.1 of the Act), paragraph 138.1(1)(*i*) does not apply in respect of a disposition of an interest in the transferor that occurs in connection with the qualifying disposition. Consequently, no capital loss is provided on the qualifying disposition under paragraph 138.1(1)(*i*) in respect of load fees associated with a policyholder's interest in the transferor. Paragraph 107.4(3)(*g*) also ensures that such amounts can ultimately be recognized on a disposition of an interest in the transferee trust.

Paragraph 107.4(3)(*h*) applies if the transferor was a trust to which property was transferred by an individual (other than a trust) in anticipation of ceasing to reside in Canada and in circumstances to which subsection 73(1) applied. For the purposes of paragraph 104(4)(*a*.3), the transferee trust is likewise deemed to be a trust to which the individual had transferred property in circumstances to which subsection 73(1) applied and in anticipation of ceasing to reside in Canada. Thus, as a consequence of new paragraph 104(4)(*a*.3), there may be a deemed disposition by the transferee trust on the individual ceasing to reside in Canada. Paragraph 107.4(3)(*h*) also applies, where property was transferred by an individual (other than a trust) to the transferor trust in circumstances to which subsection 107.4(3) would apply if no exception under subsection 107.4(1) were made for either transfers to which subsection 73(1) applied or transfers that included the giving to the transferor of any consideration. In these circumstances, the transferee trust is deemed for the purposes of paragraph (*j*) of the definition "excluded right or interest" in subsection 128.1(10) to be a trust an interest in which was acquired by the individual as a consequence of a qualifying disposition. Thus, gains with regard to an interest in the transferee trust would be required to be recognized in the event that the individual subsequently ceases to reside in Canada.

Paragraph 107.4(3)(*i*) applies where the transferor was a trust that was neither a personal trust nor a trust prescribed for the purposes of subsection 107(2). In these circumstances, the transferee trust is likewise deemed to be neither a personal trust nor a trust prescribed for the purposes of subsection 107(2).

Paragraph 107.4(3)(*j*) applies where, as a result of a qualifying disposition from one trust to another trust, a taxpayer disposes of the taxpayer's capital interest in the transferor trust and acquires a capital interest in the transferee trust. In these circumstances, the taxpayer is deemed to dispose of the capital interest in the transferor trust for proceeds equal to the cost amount to the taxpayer of that interest. The taxpayer is also generally deemed to acquire the interest in the transferee trust at that same cost amount. However, the deemed cost amount to the taxpayer of the taxpayer's capital interest in the transferee trust is reduced in some cases where the fair market value of the taxpayer's capital interest in the transferor trust is less than its cost amount to the taxpayer. The reduction in these cases is equal to a hypothetical reduction in the transferor's loss on the disposition of the property. This hypothetical reduction is computed, using the stop-loss rules with regard to trust interests (paragraphs 107(1)(*c*) and (*d*)), on the assumption that the proceeds of disposition are the fair market value of the property rather than its cost amount.

Paragraph 107.4(3)(*k*) applies where the transferor is a trust and a taxpayer's beneficial ownership in property ceases because of a qualifying disposition to be derived from the taxpayer's capital interest in the transferor, but no part of the taxpayer's capital interest in the transferor was disposed of because of the qualifying disposition. In these circumstances, the taxpayer's cost of the taxpayer's capital interest in the transferee trust is increased to reflect the percentage change (attributable to the disposition) in value of the taxpayer's capital interest in the transferee trust. However, the cost amount of the taxpayer's interest in the transferee trust is reduced where the fair market value of the taxpayer's capital interest in the transferor is less than its cost amount to the taxpayer and, had the capital interest in the transferor trust been disposed of, the taxpayer's loss from that hypothetical disposition would have been reduced under the stop-loss rules for trust interests (paragraphs 107(1)(*c*) and (*d*)).

Paragraph 107.4(3)(*l*) generally provides that any amount added under that paragraph in computing the cost to a taxpayer of the taxpayer's capital interest in a transferee trust is deducted in computing the cost to a taxpayer of the taxpayer's capital interest in the transferor. However, the amount of the deduction does not take into account the reduction under paragraph 107.4(3)(*k*) in respect of the stop-loss rules for trust interests.

Where paragraphs 107.4(3)(*j*) and (*k*) do not apply, paragraph 107.4(3)(*m*) deems the cost to the transferor of the capital interest in the transferee trust acquired on the disposition to be

- where the transferee is a personal trust, nil, and
- in any other case, the excess determined under paragraph 107.4(3)(*b*).

Paragraph 107.4(3)(*n*) applies to a qualifying disposition that is a disposition of a property between two personal trusts. Where, because of the qualifying disposition, a taxpayer disposes of an income interest (as defined in subsection 108(1)) in the transferor trust and acquires an income interest in the transferee trust, for the purpose of subsection 106(2) the taxpayer is deemed not to dispose of any part of the income interest in the transferor trust. This measure is limited to personal trusts because an income interest only exists in respect of such trusts.

These amendments apply to dispositions that occur after December 23, 1998 except that, in its application to dispositions that occurred in taxation years that ended before February 28, 2000, the reference in subparagraph 107.4(3)(*e*)(ii) to "paragraph 14(1)(*b*)" is to be read as a reference to "subparagraph 14(1)(*a*)(v) or paragraph 14(1)(*b*)". In addition, in order to ensure that there will be a cost assigned in certain cases to property previously transferred, these amendments also apply, except for the purposes of Part XI of the Act and *Income Tax Regulations* made for the purpose of that Part, in simplified form to the 1993 and subsequent taxation years. The previous transfers to which the simplified rules apply are transfers (other than transfers to bare trusts) that were not dispositions of property because of paragraph (*e*) of the definition "disposition" in section 54. No proceeds of dispositions are ascribed to these previous transfers and the stop-loss rules in subsection 107.4(3) do not apply.

ITA
107.4(4)

New subsection 107.4(4) of the Act provides a valuation rule with regard to vested capital interests in certain trusts.

For subsection 107.4(4) to apply at any time to a taxpayer's capital interest in a trust, the following additional conditions must be satisfied:

- the interest is vested indefeasibly at that time,

- the trust is not described in any of paragraphs (*a*) to (*e*.1) of the definition "trust" in subsection 108(1), (generally trusts relating to employee compensation and retirement savings and trusts deemed to exist for income tax purposes), and

- capital interests in the trust are not ordinarily disposed of for consideration that reflects the fair market value of the net assets of the trust.

In these circumstances, the fair market value of the capital interest is deemed to be not less than its "share" of the total net assets of the trust. More specifically, the fair market value of the capital interest is deemed to be not less than the product obtained by multiplying the fair market value of the net assets (i.e., assets minus liabilities) of the trust by the proportion of the fair market value of the particular interest (determined without reference to subsection 107.4(4)) to the total fair market value of all beneficial interests in the trust (determined without reference to subsection 107.4(4)).

These amendments apply to dispositions of capital interests that occur after December 23, 1998.

## Clause 83

## Taxation of Trusts and Their Beneficiaries

ITA
108

Section 108 of the Act sets out certain definitions and rules that apply for the purposes of subdivision k, which deals with the taxation of trusts and their beneficiaries.

### Definitions

ITA
108(1)

"accumulating income"

The amount that may be allocated under subsection 104(15) of the Act to a disabled beneficiary for a trust taxation year is limited to the trust's accumulating income for the year. The trust's accumulating income is designed, in part, to ensure that the preferred beneficiary election cannot be used to allocate income and gains under a trust for the benefit of a spouse or common-law partner to non-spouse or non-common-law partner beneficiaries. Under the existing definition, trust income arising from a deemed disposition of trust assets under subsection 104(4), (5) or (5.2) is not included in computing "accumulating income" and cannot be allocated to beneficiaries in the event that the trust is a trust for the benefit of a spouse or common-law partner.

The definition "accumulating income" is amended so that the above restriction only applies in connection with the deemed disposition of trust assets that occurs on the death of the spouse or common-law partner beneficiary under a trust for the benefit of the spouse or common-law partner. As a consequence of amendments to paragraph 104(4)(*a*), a similar restriction applies to *alter ego* trusts and joint spousal or common-law partner trusts, as defined in subsection 248(1).

This amendment applies to the 2000 and subsequent taxation years.

This amendment also reflects changes effected by the *Modernization of Benefits and Obligations Act*.

"capital interest"

Subsection 108(1) of the Act contains the definition "capital interest". In the case of a personal trust, a prescribed trust and certain "grandfathered" trusts, a taxpayer's capital interest encompasses all rights of the taxpayer to receive all or any part of the trust's capital. In any other case, a taxpayer's capital interest generally encompasses all rights of the taxpayer as a beneficiary under the trust.

The definition "capital interest" is amended to expressly provide that a capital interest does not include an income interest in the trust. With the exception of an income interest in a trust, a taxpayer's capital interest in a trust encompasses:

- all rights of the taxpayer as a beneficiary under any type of trust, and
- after 1999, a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment by the trust that arises as a consequence of any such rights.

This amendment applies after 1999.

Note, in addition, that an amendment to subsection 104(1) has the effect of excluding a "bare trust" from the definition "trust" in the Act. One of the effects of this amendment is that there will be no capital interests in a "bare trust" for the purposes of the Act.

"cost amount"

The calculation of the "cost amount" of a taxpayer's capital interest in a trust is primarily relevant for the purposes of determining a taxpayer's capital gain from the disposition of the taxpayer's capital interest in a personal trust. Under paragraph 107(1)(*a*) of the Act, for capital gains calculation purposes, the adjusted cost base (ACB) of a taxpayer's capital interest is generally the greater of the ACB otherwise determined and the cost amount of the taxpayer's interest determined under subsection 108(1).

Under the existing definition, the cost amount of a taxpayer's capital interest in a trust satisfied by way of a distribution of money is equal to the money distributed. The cost amount of a capital interest satisfied by way of the distribution of other property is equal to the sum of the cost amounts to the trust of those properties. In cases where a capital interest is disposed of without any distribution, the cost amount of a taxpayer's capital interest is considered to be the taxpayer's proportionate share of the trust's money on hand and the total cost amount of other trust property, offset by outstanding trust liabilities. The purpose of the existing definition is essentially to give beneficiaries of personal trusts recognition for cost amounts of trust assets, given that the cost of capital and income interests in such trusts will generally be nil because of the operation of subsections 106(1.1) and 107(1.1).

The definition is amended so that it does not apply for the purpose of section 107.4. This amendment applies to the 1993 and subsequent taxation years, in order to be consistent with the coming into force for section 107.4.

New paragraph (*a*.1) of the definition is introduced to provide a special rule in the event that an individual is deemed to dispose of a capital interest in a trust immediately before the individual's death. If on the individual's death there is also a deemed disposition of trust assets and an immediate subsequent deemed reacquisition because of the operation of amended paragraph 104(4)(*a*) or (*a*.4), that deemed reacquisition is considered to occur immediately before the individual's death in order that the "cost amount" of the individual's capital interest reflects the deemed disposition of trust assets. This amendment is intended to prevent double taxation of the same economic gain in these circumstances. This amendment applies to deaths that occur after 1999, and, where a day is determined under paragraph 104(4)(*a*.4) in respect of a trust, the trust elects in writing and files the election with the Minister of National Revenue on or before March 31, 2001 (or at a later time that is acceptable to the Minister), the amendment applies to deaths that occur after December 23, 1998.

"eligible offset"

Subsection 108(1) of the Act is amended to introduce the expression "eligible offset".

A taxpayer's "eligible offset" in respect of all or part of a taxpayer's capital interest in a trust reduces the taxpayer's proceeds of disposition arising from the satisfaction of all or part of that interest, in the event there is a distribution to which amended subsection 107(2) or (2.1) applies. Where such a distribution was conditional upon the assumption by the taxpayer of a debt or obligation, the taxpayer's eligible offset at any time of in respect of that interest is the portion of the debt or obligation assumed by the taxpayer that can reasonably be considered to be applicable to the property distributed at that time in satisfaction of that interest.

This amendment applies after December 23, 1998. For further detail of the effect of this amendment, see the notes on amendments to subsections 107(2) and (2.1).

"exempt property"

Subsection 108(1) of the Act introduces the definition "exempt property". The expression is used in amended subsections 104(4) to (5.2). For further detail, see the notes above on those subsections.

This amendment applies after 1992.

"income interest"

Subsection 108(1) of the Act contains the definition "income interest". It is defined as a right as a beneficiary under a personal trust to income of the trust. Under subsection 108(3), "income" for this purpose is determined without reference to the provisions of the Act.

The definition is amended to provide that, after 1999, an income interest also includes a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment by the trust that arises as a consequence of a right that is an income interest.

Except as noted above, these amendments apply in respect of interests created or materially altered after January 31, 1987 that were acquired after 10 p.m. Eastern Standard Time, February 6, 1987.

"trust"

Subsection 108(1) of the Act defines "trust", for the purposes of the 21-year deemed disposition rule and other specified measures, to exclude certain listed trusts. For these purposes, paragraph (*f*) of the definition excludes unit trusts (as defined in subsection 108(2)) and paragraph (*g*) of the definition excludes, except as specified, trusts all interests in which have vested indefeasibly and no interest in which may become effective in the future. One of the specified exceptions from the exclusion under paragraph (*g*) is for trusts described in paragraph 104(4)(*a*) (which, under the existing law, describes only a trust for the benefit of a spouse or common-law partner).

Paragraph (*a*.1) is added to the definition so that the exclusion from the 21-year deemed disposition rule and other rules applies to a trust (other than a trust already described in paragraph (*a*) or (*d*) of the definition) all or substantially all of the property of which is held for the purpose of providing benefits to individuals each of whom is provided with benefits in respect of, or because of, an office or employment or former office or employment. It is generally intended that health and welfare trusts qualify for the exclusion, given that these trusts would not be expected to be described in paragraph (*a*) or (*d*) of the definition. This amendment applies to the 1999 and subsequent taxation years.

The definition is also amended so that the exclusion under paragraphs (*f*) and (*g*) also apply for the purpose of the rules in section 106 governing the taxation of income interests.

Paragraph (*g*) of the definition is amended so that the exclusion can apply to a trust all interests in which have vested indefeasibly, without regard to whether an interest in the trust becomes effective in the future. However, under new subparagraph (*g*)(v), the exclusion generally does not apply to a trust under the terms of which all or part of any person's interest is to be terminated with reference to a period of time.

The elimination of the requirement that there be no future interest and its replacement by subparagraph (*g*)(v) applies to the 1998 and subsequent taxation years. However, where the trust so elects in writing before its filing-due date for its taxation year that includes the date of Royal Assent (or before such later day as is acceptable to the Minister of National Revenue), these amendments apply only after 2000.

> ***Example***
>
> *A trust provides for beneficiary A to receive income from property for the lifetime of beneficiary A with the remainder interest to go beneficiary B (or the estate of beneficiary B, if beneficiary B does not survive beneficiary A). The above amendment clarifies that the above exclusion from the 21-year rule does not apply in this case. On the other hand, where new units in a trust can be issued by a commercial trust for fair market value consideration, the above amendment ensures that the trust is not precluded from qualifying for the exclusion.*

New subparagraph (*g*)(iv) of the definition ensures that the above exclusion does not apply to a trust resident in Canada that has a non-resident beneficiary, unless the total fair market value of the interests of the non-resident beneficiaries is 20% or less of the total fair market value of the interests in the trust. This 20% level is meant to accommodate a limited level of foreign ownership of interests in the trust, given that gains in respect of those interests may not be subject to Canadian taxes because of income tax treaties. This amendment applies after December 23, 1998.

New subparagraph (*g*)(vi) of the definition ensures that the above exclusion does not apply to a trust that, after December 17, 1999, made a distribution to a beneficiary in respect of the beneficiary's capital interest in the trust, if the distribution may reasonably be considered to have been financed by a liability of the trust and one of the purposes of incurring the liability was to avoid taxes otherwise payable under Part I of the Act as a consequence of the death of any individual. This provision parallels new paragraph 104(4)(*a*.2), described in the notes above.

Except as noted above, these amendments apply to the 1998 and subsequent taxation years.

ITA
108(2)

Subsection 108(2) of the Act describes the requirements for a trust to be a "unit trust" (as defined in subsection 248(1)). A trust must be a unit trust to qualify as a "mutual fund trust" under subsection 132(6).

Paragraph 108(2)(*b*) is amended to allow a trust to qualify as a unit trust throughout a taxation year, provided that at all times throughout the year the trust meets the conditions set out in either paragraph 108(2)(*a*) or (*b*). This ensures that a trust will not lose its status as a unit trust only because it converts from a unit trust described in paragraph 108(2)(*b*) to a unit trust described in paragraph 108(2)(*a*) or *vice versa.*

The closing words of paragraph 108(2)(*b*) provide that a trust, more than 20% of the assets of which consist of real property situated in Canada, may qualify as a unit trust under paragraph 108(2)(*b*) only if its units are listed on a prescribed stock exchange in Canada. These closing words are replaced by subparagraph 108(2)(*b*)(vi). This subparagraph reflects past amendments to subsection 108(2).

Paragraph 108(2)(*b*) is also amended to add a reference to "hypothecary claim" to the list of properties the combination of which must account for at least 80 per cent of a trust's total properties. This amendment is made to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

These amendments apply to the 1998 and subsequent taxation years.

ITA
108(3)

Subsection 108(3) of the Act provides that a trust's income is generally its income computed without reference to the provisions of the Act. Subsection 108(3) applies for the purposes of the rules in subsection 73(1) governing a trust for the benefit of a spouse or common-law partner, as well as other specified purposes.

Subsection 108(3) is amended to change a cross-reference to paragraph 73(1)(*c*) to a cross-reference to new paragraph 73(1.01)(*c*).

This is a technical change consequential to amendments to section 73, described in the notes above.

This amendment applies to the 2000 and subsequent taxation years.

ITA
108(4)

Subsection 108(4) of the Act provides that a trust is not disqualified as a trust for the benefit of a spouse or common-law partner under a number of specified provisions in the Act merely because of the payment of estate, income or similar taxes.

Subsection 108(4) is amended so that this rule applies not only to a trust for the benefit of a spouse or common-law partner but also to trusts established for the exclusive benefit of the settlor during the settlor's lifetime and to trusts established for the joint benefit of the settlor and the settlor's spouse or common-law partner during their lifetimes. This amendment is consequential to changes to section 73 that are described in the notes above.

This amendment applies to the 2000 and subsequent taxation years.

This provision is further amended to reflect changes effected by the *Modernization of Benefits and Obligations Act*.

ITA
108(6)

Subsection 108(6) of the Act applies where the terms of a trust are varied. It provides that the application of the 21-year deemed disposition rule is not affected by the variation.

Subsection 108(6) is amended to ensure that no interest of a beneficiary under the trust before it was varied is considered to be consideration for the interest of the beneficiary in the trust as varied. This rule is relevant for a number of specified provisions in the Act, which refer to trust interests being acquired for consideration.

This amendment applies to the 2000 and subsequent taxation years. The amendment is intended to extend to all trust variations, including variations that occurred before 2000.

ITA
108(7)

A "personal trust" is defined in subsection 248(1) of the Act as essentially a testamentary trust or an *inter vivos* trust in which no beneficial interest was acquired for consideration payable to the trust or to a contributor to the trust. An existing rule within the definition generally ensures that one person (or two or more related persons) can make contributions to a trust and retain an interest under the trust without the prohibition on consideration being considered to apply. This existing rule also applies for the purposes of paragraph 53(2)(*h*), which deals with the calculation of the adjusted cost bases of certain trust interests.

The definition is amended so that this rule is removed from the definition. Instead, the rule is now provided in new subsection 108(7). The rule is also to apply, under subsection 108(7), for the purposes of amended subsection 107(1), as a consequence of the amendments to that provision, and for the purposes of paragraph (*j*) of the new definition "excluded right or interest" in subsection 128.1(10).

New subsection 108(7) also ensures that, for the purposes of the above-noted provisions, an interest in a trust is deemed not to be acquired for consideration solely because of the acquisition of the interest in satisfaction of any right as a beneficiary under the trust to enforce payment from the trust.

New subsection 108(7) applies after December 23, 1998.

## Clause 84

## Taxable Income – Deductions

ITA
110

Section 110 of the Act provides various deductions that may be claimed in computing a taxpayer's taxable income.

**Employee Options**

ITA
110(1)(*d*)

Paragraph 110(1)(*d*) of the Act provides a deduction in computing taxable income when an employee is deemed, by subsection 7(1) of the Act, to have received a benefit from employment in connection with the exercise or disposition of rights under an employee option agreement. The deduction is equal to 1/4 of the amount of the employment benefit. The effect of the deduction is to have the benefit taxed at a rate equivalent to the capital gains inclusion rate.

In order to qualify for the deduction under paragraph 110(1)(*d*), the following three conditions must be satisfied:

- The security that is the subject of the option must be either a prescribed share (as defined in section 6204 of the *Income Tax Regulations*) or a unit of a widely-held class of units of a mutual fund trust. This condition is set out in subparagraph 110(1)(*d*)(i).

- The exercise price (that is, the amount payable by the employee to acquire the security under the option) must be at least equal to the fair market value of the security when the option was granted (less any amount paid by the employee to acquire the option). If the option being exercised or disposed of was acquired by the employee as a result of one or more exchanges of options to which subsection 7(1.4) applied, this condition applies to the original option. This condition is set out in clauses 110(1)(*d*)(ii)(A) and (iii)(A), and is referred to in these notes as the "exercise price test".

- At the time immediately after the option was granted, the employee must have been dealing at arm's length with the entity granting the option (the "grantor") and with each entity not dealing at arm's length with the grantor. If the option being exercised or disposed of was acquired by the employee as a result of one or more exchanges to which subsection 7(1.4) applied, this condition applies to each new option, but not to the original option. This condition is set out in clauses 110(1)(*d*)(ii)(B) and (iii)(B), and is referred to in these notes as the "arm's length test".

Paragraph 110(1)(*d*) is amended in the following ways.

## Amount of Deduction

Paragraph 110(1)(*d*) is amended as a consequence of changes to the capital gains inclusion rate. Specifically, the deduction that an employee may claim under this paragraph is increased from 1/4 to 1/3 of the amount of the employment benefit that the employee is deemed, by subsection 7(1) of the Act, to have received, if the transaction which results in the recognition of the employment benefit occurs after February 27, 2000 and before October 18, 2000. Similarly, if the transaction occurs after October 17, 2000, the deduction is increased to 1/2.

Where an employee acquires an option security under circumstances to which subsection 7(1.1) or (8) applies, it is the disposition of the security which results in the recognition of the employment benefit, and thus determines the amount of the deduction available under paragraph 110(1)(*d*). In all other cases, it is the exercise or disposition of the option which results in the recognition of the benefit, and thus determines the amount of the deduction available under paragraph 110(1)(*d*).

### *Example*

*A share acquired in June 2000 under an employee option granted by a Canadian-controlled private corporation (CCPC) is sold in November 2000. In accordance with subsection 7(1.1), the sale of the share results in the employee being deemed, by subsection 7(1), to have received a benefit from employment. Since the sale occurred after October 17, 2000, the deduction available under paragraph 110(1)(d) would be 1/2 of the employment benefit.*

*If the share were acquired under a non-CCPC option and there were no deferral under subsection 7(8), the acquisition of the share would result in the recognition of the benefit. Since the acquisition occurred after February 27 but before October 18, 2000, the deduction available under paragraph 110(1)(d) would be 1/3 of the employment benefit.*

*Exercise Price Test*

Paragraph 110(1)(*d*) is amended to clarify the application of the exercise price test where there has been an exchange of options in accordance with subsection 7(1.4) of the Act.

Specifically, subparagraph 110(1)(*d*)(iii) – which applies when the option being exercised or disposed of was acquired by the employee as a result of one or more exchanges of options in accordance with subsection 7(1.4) – is amended to require that the following conditions be satisfied:

- The closing exercise price under the original option (that is, the exercise price under the original option at the time it was exchanged) must not be less than the fair market value of the underlying security at the time the option was granted minus any amount paid by the employee to acquire the option. This condition is set out in new clause 110(1)(*d*)(iii)(C) and essentially replicates the condition currently set out in clause 110(1)(*d*)(iii)(A).

- For each subsequent exchange, the closing exercise price under the option being given up must not be less than the opening exercise price under that option (that is, the exercise price that was set under that option when it was granted). This condition is set out in new clause 110(1)(*d*)(iii)(D).

- For the option which is being exercised or disposed of (and which is, thus, giving rise to the deemed employment benefit under subsection 7(1)), the exercise price at the time of exercise or disposition, as the case may be, must not be less than the opening exercise price under that option. This condition is set out in amended clause 110(1)(*d*)(iii)(A).

In applying these conditions, reference must be made to subsection 7(1.4). That subsection provides that, where there is an exchange of employee security options within a related group (or on a corporate amalgamation or merger), the exchange is disregarded for the purposes of section 7 so long as the employee derives no economic gain from the exchange. As a consequence of the application of subsection 7(1.4), the disposition of the old options does not give rise to an employment benefit under subsection 7(1).

In determining whether or not an employee has derived an economic gain from an exchange of options, paragraph 7(1.4)(*c*) compares the potential benefit under the new options to the potential benefit under the old options.

- The potential benefit under the new options is determined by subtracting the total exercise price under those options immediately after the exchange (subparagraph 7(1.4)(*c*)(ii)) from the total value at that time of the securities underlying those options (subparagraph 7(1.4)(*c*)(i)). This is relevant for amended subparagraph 110(1)(*d*)(iii) in that the amount included in subparagraph 7(1.4)(*c*)(ii) on a per-security basis represents the opening exercise price under those options.

- Similarly, the potential benefit under the old options is determined by subtracting the total exercise price under those options immediately before the exchange (subparagraph 7(1.4)(*c*)(iv)) from the total value at that time of the securities underlying those options (subparagraph 7(1.4)(*c*)(iii)). This is relevant for amended subparagraph 110(1)(*d*)(iii) in that the amount included in subparagraph 7(1.4)(*c*)(iv) on a per-security basis represents the closing exercise price under those options.

In effect, subparagraph 110(1)(*d*)(iii) sets a benchmark exercise price for each option. Under the original option, the benchmark is the fair market value of the underlying shares at the time the option is granted. For each subsequent option, the benchmark is the exercise price set when the option is acquired (i.e., the "opening exercise price").

It should be noted that amended subsection 110(1.5) of the Act contains a number of provisions that affect the calculation of amounts for the purposes of paragraph 110(1)(*d*). Specifically, it provides for currency fluctuations to be disregarded in determining the exercise price under an option. (This is currently provided for in paragraph 110(1)(*d*), but is being moved to subsection 110(1.5).) It also provides for the fair market value of an employee option security, and the opening exercise price under an option acquired in an exchange of options, to be adjusted for structural changes (such as a split or consolidation of shares) occurring after the option is granted. (See the commentary on amended subsection 110(1.5) for further details.)

The following example illustrates the application of the conditions of paragraph 110(1)(*d*) relating to exercise price when there has been an exchange of options and a stock split.

***Example***

*Original Grant:*

*Pierre is granted an option to acquire 2 shares of his corporate employer, Company A, at an exercise price of $5 a share. The shares have a fair market value (FMV) at the time of the grant of $5.*

*First Exchange:*

*As a result of a corporate merger, Pierre's option on Company A shares is exchanged for an option on the shares of the successor company, Company B. At the time, Company A shares have a FMV of $25 each and Company B shares have a FMV of $50 each. The new option allows Pierre to acquire 1 Company B share at an exercise price of $10. The exchange satisfies the requirements of subsection 7(1.4). The "per share" amounts included in subparagraph 7(1.4)(c)(ii) (i.e., the opening exercise price on the Company B share) and subparagraph 7(1.4)(c)(iv) (i.e., the closing exercise price on the Company A shares) are $10 and $5, respectively.*

*Specified Event:*

*After the merger, there is a 5-for-1 split on the shares of Company B. Pierre's option to acquire 1 share of Company B for $10 is automatically adjusted to allow him to acquire 5 shares of Company B at $2 each.*

*Second Exchange:*

*As a result of a second corporate merger, Pierre's option on Company B shares is exchanged for an option on the shares of the successor company, Company C. At the time, Company B shares have a FMV of $20 each and Company C shares have a FMV of $10 each. The new option allows Pierre to acquire 10 Company C shares at an exercise price of $1 per share. The exchange satisfies* *the requirements of subsection 7(1.4). The "per share" amounts included in subparagraph 7(1.4)(c)(ii) (i.e., the opening exercise price on the Company C shares) and subparagraph 7(1.4)(c)(iv) (i.e., the closing exercise price on the Company B shares) are $1 and $2, respectively.*

*Exercise:*

*When the Company C shares have a value of $21 each, Pierre exercises his option and acquires 10 shares. Under paragraph 7(1)(a), Pierre is deemed to have received a benefit from employment equal to $200 (= ($21 - $1) x 10).*

*Exercise Price Test:*

*Since the option under which Pierre acquired the Company C shares is not the original option, the exercise price conditions in subparagraph 110(1)(d)(iii) – rather than subparagraph 110(1)(d)(ii) – must be satisfied.*

*The exercise price test in clause 110(1)(d)(iii)(A) applies to the option on the Company C shares (i.e., the option under which the share is acquired). That clause requires that the amount that Pierre paid to acquire each of the Company C shares be not less than the exercise price that was set when Pierre received the options on the Company C shares (i.e., the "per share" amount included in subparagraph 7(1.4)(c)(ii) on the second exchange). Since the amount paid ($1 a share) was not less than the opening exercise price on the Company C shares ($1 a share), this condition is satisfied.*

*The exercise price test in clause 110(1)(d)(iii)(C) applies to the option on the Company A shares (i.e., the original option). That clause requires that the exercise price under the original option at the time it was exchanged (i.e., the "per share" amount included in subparagraph 7(1.4)(c)(iv) on the first exchange) be not less than the FMV of the Company A shares at the time the option was granted. Since the closing exercise price on the original option ($5 a share) was not less than the FMV of the company A shares at the time the original option was granted ($5 a share), this condition is satisfied.*

*Clause 110(1)(d)(iii)(D) applies to the option on the Company B shares (i.e., the option which is neither the original option nor the option under which the share is acquired). That clause requires that the exercise price under the option at the time it was exchanged for the option on the Company C shares (i.e., the "per share" amount included in subparagraph 7(1.4)(c)(iv) on the second exchange) be not less than the exercise price that was set when Pierre received the option on the Company B shares (i.e., the "per share" amount included in subparagraph 7(1.4)(c)(ii) on the first exchange). However, in accordance with new paragraph 110(1.5)(c), the opening exercise price is adjusted for this purpose to reflect the 5-for-1 split. Thus, the opening exercise price of $10 a share is adjusted to $2 a share. Since the closing exercise price on the Company B shares ($2 a share) is not less than the adjusted opening price, this condition is satisfied.*

### *Arm's Length Test*

The arm's length test is amended in two ways.

First, the entities with which the employee must be dealing at arm's length is narrowed. Rather than having to be at arm's length with the grantor and any entity not dealing at arm's length with the grantor, the employee must be at arm's length with the grantor, the employer and the entity whose securities can be acquired under the option. This is less restrictive than the existing condition in that an employee who is not dealing at arm's length with a particular entity which is not dealing at arm's length with the grantor will not be precluded from claiming the deduction under paragraph 110(1)(*d*) because of that relationship, so long as the particular entity is neither the employee's employer nor the entity whose securities can be acquired under the option.

Second, the arm's length test is amended so that, where there has been an exchange of options under subsection 7(1.4), the test is applied with respect to the original option and not with respect to any subsequent exchange of options.

The amendments to the arm's length test correct recent legislative changes that, inadvertently, had a tightening effect (extending the test to all persons not dealing at arm's length with the grantor) and a relieving effect (ceasing to apply the test to the original option after an exchange). They also further relax the test by restricting its application to the original option when there has been an exchange of options.

The amendments to paragraph 110(1)(*d*) apply to the 1998 and subsequent taxation years.

## Charitable Donation of Employee Option Securities

ITA
110(1)(*d*.01)

New paragraph 110(1)(*d*.01) of the Act allows an employee to deduct a portion of the employment benefit that the employee is deemed by subsection 7(1) of the Act to have received in connection with the acquisition of a security under an employee option agreement, if the employee donates the security to a qualified donee (other than a private foundation). For this purpose, a "security" (as defined in subsection 7(7) of the Act) means a share of the capital stock of a corporation or a unit of a mutual fund trust. A "qualified donee" (as defined in subsection 248(1) of the Act by reference to subsection 149.1(1) of the Act) means, in general terms, a person to whom gifts may be made that qualify for the charitable donations deduction or tax credit.

In order to qualify for a deduction under new paragraph 110(1)(*d*.01), the employee must also be eligible for the regular employee option deduction under paragraph 110(1)(*d*). (In general terms, this means that (i) the employee was dealing at arm's length, when the option was granted, with the employer, the grantor of the option and the person whose security was acquired under the option, (ii) the option was not issued at a discount and (iii) the security, if it is a share, is an ordinary common share.) The combined effect of the two deductions is to tax the employment benefit on the donated security at a rate that is comparable to the reduced capital gains inclusion rate provided under paragraph 38(*a*.1) of the Act for securities donated to a charity.

The additional deduction under paragraph 110(1)(*d*.01) is available for donated securities acquired after February 27, 2000 and before 2002. In order to qualify for the deduction, the donation must be made in the same year as the security is acquired and no later than

30 days after acquisition. If the security is a share, it must be of a class of shares listed on a Canadian or foreign stock exchange described in section 3200 or 3201 of the *Income Tax Regulations*.

The amount of the deduction under new paragraph 110(1)(*d*.01) depends on the amount of the regular deduction under paragraph 110(1)(*d*). If the regular deduction is 1/3 of the employment benefit, the additional deduction is also 1/3, and the net result is that only 1/3 of the employment benefit is subject to tax. If the regular deduction is 1/2, the additional deduction is 1/4, and the net result is that only 1/4 of the employment benefit is subject to tax. Generally, the 1/3 rate applies to securities acquired after February 27, 2000 and before October 18, 2000, and the 1/4 rate applies to securities acquired after October 17, 2000.

It should be noted that if the security is worth less when it is donated than when it was acquired, the additional deduction under paragraph 110(1)(*d*.01) is based on the employment benefit that the employee would have been deemed by subsection 7(1) to have received if the value of the security at the time of acquisition were that lesser value.

It should also be noted that, if the employee owns other securities that are identical to the security acquired under the employee option agreement, new subsection 7(1.31) may apply to deem the option security as the security being donated. In these circumstances, new subsection 47(3) also applies to exempt the security from the cost-averaging rule in subsection 47(1). Consequently, the adjusted cost base of the donated security, and thus the capital gain or loss on the disposition of the security, is determined without regard to the adjusted cost base of any other securities acquired by the employee.

Finally, it should be noted that, by virtue of new subsection 110(2.1), the deduction under paragraph 110(1)(*d*.01) may also be available where an employee sells an employee option security and donates all or part of the proceeds of the disposition to a qualifying charity. To qualify, certain conditions must be met regarding the acquisition and disposition of the security, and the donation of the proceeds of disposition to charity. Furthermore, the deduction will be prorated to reflect the proportion of the proceeds that are donated.

## Employee Options

ITA
110(1)(*d*.1)

Paragraph 110(1)(*d*.1) of the Act provides a deduction in computing the taxable income of a taxpayer where the taxpayer has included an amount in income for the year under paragraph 7(1)(*a*) of the Act as a result of a disposition or exchange of a share acquired under an employee stock option granted by a Canadian-controlled private corporation.

The paragraph is amended to replace the reference to the fraction "1/4" with a reference to the fraction "1/2", and is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies with respect to dispositions and exchanges that occur after February 27, 2000 except that, for dispositions and exchanges that occur after February 27, 2000 and before October 18, 2000, the reference to the fraction "1/2" is to be read as a reference to the fraction "1/3". These modifications are required in order to reflect the capital gains/losses rate for the year.

## Prospector's and Grubstaker's Shares

ITA
110(1)(*d*.2)

Paragraph 110(1)(*d*.2) of the Act provides a deduction in computing the taxable income of a taxpayer where the taxpayer has included an amount in income for the year under paragraph 35(1)(*d*) of the Act as a result of a disposition or exchange of a share acquired in exchange for an interest in a mining property.

The paragraph is amended to replace the reference to the fraction "1/4" with a reference to the fraction "1/2", and is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies with respect to dispositions and exchanges that occur after February 27, 2000 except that, for dispositions and exchanges that occur after February 27, 2000 and before October 18, 2000, the reference to the fraction "1/2" is to be read as a reference to the fraction "1/3". These modifications are required in order to reflect the capital gains/losses rate for the year.

## Employer's Shares

ITA
110(1)(*d*.3)

Paragraph 110(1)(*d*.3) of the Act provides a deduction in computing the taxable income of a taxpayer where the taxpayer has included an amount in income for the year under subsection 147(10.4) of the Act as a result of a disposition or exchange of employer shares that had previously been received as part of a single payment from a deferred profit sharing plan.

The paragraph is amended to replace the reference to the fraction "1/4" with a reference to the fraction "1/2", and is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies with respect to dispositions and exchanges that occur after February 27, 2000 except that, for dispositions and exchanges that occur after February 27, 2000 and before October 18, 2000, the reference to the fraction "1/2" is to be read as a reference to the fraction "1/3". This modification is required in order to reflect the inclusion rate for capital gains realized during that period.

## Determination of Amounts Relating to Employee Security Options

ITA
110(1.5)

Subsection 110(1.5) of the Act contains a special rule that is relevant for purposes of determining eligibility for the deduction under paragraph 110(1)(*d*) in respect of certain stock option benefits.

Specifically, subsection 110(1.5) requires that, for the purposes of subparagraph 110(1)(*d*)(iii), certain changes in share structure that occur after a stock option is granted be considered in determining the fair market value of the shares at the time the option was granted. For example, where there is a one-for-two consolidation of stock option shares after the options are granted but before they are exercised, the fair market value of the shares at the time the options were granted would, for purposes of subparagraph 110(1)(*d*)(iii), be considered to be twice the actual value of the shares at that time.

Subsection 110(1.5) is amended in a number of ways.

First, it is amended so that it applies for all purposes of paragraph 110(1)(*d*), not just for the purposes of subparagraph 110(1)(*d*)(iii).

Second, it is amended so that it applies to units of a mutual fund trust as well as to shares of the capital stock of a corporation.

Third, it is amended to replace the detailed description of the specific structural changes that are to be taken into account in determining a security's fair market value with a simple reference to "specified events" (as defined in new subsection 110(1.6) of the Act).

Fourth, it is amended to provide that, in determining the opening exercise price of an option that has been received in exchange for another option under circumstances to which subsection 7(1.4) of the Act applies, all "specified events" (as defined in subsection 110(1.6)) that occur after the option is granted, and before it is exercised or exchanged or otherwise disposed of, are to be taken into account. This is relevant in determining if the condition in clause 110(1)(*d*)(iii)(A) or (D), as the case may be, is satisfied when the new option is subsequently exercised, exchanged or otherwise disposed of. This provision is set out in new paragraph 110(1.5)(*c*). (The application of paragraph 110(1.5)(*c*) is illustrated in the example set out in the "Exercise Price Test" commentary on paragraph 110(1)(*d*).)

Finally, subsection 110(1.5) is amended to provide for the exercise price under an employee option agreement to be determined without reference to changes in the value of a foreign currency relative to Canadian currency after the option is granted. This is currently provided for in paragraph 110(1)(*d*), but is being moved to amended paragraph 110(1.5)(*a*).

These changes, which apply to the 1998 and subsequent taxation years, are consequential to changes to paragraph 110(1)(*d*), including changes previously made in the 1998 budget bill [S.C. 1999, c.22 (formerly Bill C-72)] to extend the application of that paragraph to mutual fund trust units.

## Meaning of "Specified Event"

ITA
110(1.6)

New subsection 110(1.6) of the Act defines "specified event", which is relevant for amended subsection 110(1.5) of the Act. That subsection requires that, in determining either the fair market value of an employee option security at the time the option was granted or the opening exercise price to acquire a security under an option received in exchange for another option in accordance with subsection 7(1.4) of the Act, all specified events associated with the security that occurred after the option was granted are to be taken into account. For this purpose, a security is defined by subsection 7(7) of the Act to be a share of the capital stock of a corporation or a unit of a mutual fund trust.

Paragraph 110(1.6)(*a*) describes the events that are considered to be specified events associated with a share of the capital stock of a corporation. The events, which were previously set out in subsection 110(1.5), include a split or consolidation of shares of the corporation, a reorganization of share capital of the corporation and a stock dividend.

Paragraph 110(1.6)(*b*) describes the events that are considered to be specified events associated with a unit of a mutual fund trust. The events, which are comparable to those identified for shares, include a split or consolidation of trust units and the issuance of new units out of the income or capital of the trust. The recognition of such events in the context of a mutual fund trust is consequential to changes previously made to section 7 and paragraph 110(1)(*d*) of the Act to extend the stock option rules to mutual fund trust units.

New subsection 110(1.6) applies to the 1998 and subsection taxation years.

## Definitions in Subsection 7(7)

ITA
110(1.7)

New subsection 110(1.7) of the Act provides that the definitions "security" and "qualifying person" in subsection 7(7) of the Act apply for the purposes of amended subsection 110(1.5) and new subsection 110(1.6).

## Charitable Donation – Proceeds of Disposition of Employee Option Securities

ITA
110(2.1)

New subsection 110(2.1) of the Act allows an employee to claim a deduction under new paragraph 110(1)(*d*.01) where the employee, in exercising an option to acquire a security, directs a broker or dealer who is appointed or approved by the grantor of the option (or by an entity not dealing at arm's length with the grantor) to sell the security immediately and donate all or part of the proceeds of the disposition to a qualifying charity. The deduction is equal to the amount that would have been deductible under new paragraph 110(1)(*d*.01) if the security had been so donated, prorated to reflect the proportion of the proceeds that are donated. This deduction applies to securities acquired after February 27, 2000 and before 2002.

***Example***

*In August 2001, Julie exercises options to acquire 100 shares of her corporate employer. The exercise price is $10 a share and the fair market value at the time of acquisition is $110 a share. At her direction, the broker who is administering the stock option plan for the employer immediately sells all of the shares for proceeds of disposition equal to $11,000, pays $1,000 to the employer to cover the exercise price and pays the remaining $10,000 to a designated charity.*

*Subsection 7(1) deems Julie to have received a benefit equal to $10,000 (i.e., the fair market value of the shares at the time of acquisition less the exercise price). Julie is entitled to a deduction* *of $5,000 under paragraph 110(1)(d) (= 1/2 of $10,000). If she had donated the shares to a charity, she would have been entitled to an additional deduction of $2,500 under paragraph 110(1)(d.01) (= 1/4 of $10,000). Since she donated 90% of the proceeds from the disposition of the shares, she is entitled to deduct $2,250 under paragraph 110(1)(d.01) (= 90% of $2,500).*

## Clause 85

## Charitable Donations Deduction

ITA
110.1

Section 110.1 of the Act provides for the deductibility in computing income of charitable donations and certain other gifts.

### Ecological gifts

ITA
110.1(1)(*d*)

Subsection 110.1(1) of the Act provides a deduction in computing taxable income in respect of gifts made by corporations to registered charities and to certain other entities. Paragraph 110.1(1)(*d*) provides an exemption from the annual 75% income limit for gifts of land (including a covenant, an easement or a servitude in respect of land) that is certified by the Minister of the Environment to be ecologically sensitive land, the conservation and protection of which is, in the opinion of that Minister, important to the preservation of Canada's environmental heritage. The beneficiary must be the federal government, a provincial or territorial government, a municipality or a registered charity approved by the Minister of the Environment.

Paragraph 110.1(1)(*d*) is amended to require that the fair market value of the gift be certified by the Minister of the Environment. The fair market value is relevant to the calculation of the deduction available to the corporation under paragraph 110.1(1)(*d*) and of the taxable capital gain under section 38 of the Act.

This amendment applies to gifts made after February 27, 2000.

## Proof of Gift

ITA
110.1(2)

Subsection 110.1(2) of the Act provides that no deduction may be made in respect of a charitable donation or a gift to the Crown unless the gift is evidenced by a receipt containing prescribed information. The subsection is amended to clarify that, in the case of a gift of certified cultural property or an ecological gift, certificates issued by the Cultural Property Export Review Board or the Minister of the Environment must also be submitted.

This amendment applies to gifts made after February 27, 2000, except that the amendment in respect of cultural property does not apply to gifts made before December 21, 2000.

## Gifts of Capital Property

ITA
110.1(3)

Subsection 110.1(3) of the Act provides that, if a corporation donates capital property to a charity, it may elect a value between the adjusted cost base and the fair market value of the donated property to be treated both as the proceeds of disposition for the purpose of calculating its capital gain and the amount of the gift for the purpose of the deduction allowed for charitable donations under subsection 110.1(1).

The amendment to subsection 110.1(3) is complimentary to the amendment of subsection 110.1(5) of the Act, which provides that the fair market value of a gift of a covenant, easement or servitude in respect of ecologically sensitive land will not be considered to be less than the decrease in value of the subject land that resulted from the making of the gift. The amendments clarify that a corporate donor may nevertheless report a reduced amount as proceeds of disposition of such a gift, where the value of the gift for the purpose of the charitable donations deduction is reduced accordingly. This amendment applies in respect of gifts made after February 27, 1995.

## Ecological Gifts

ITA
110.1(5)

Subsection 110.1(5) of the Act provides that the fair market value of a gift of a covenant, easement or servitude in respect of ecologically sensitive land will not be considered to be less than the decrease in value of the subject land that resulted from the making of the gift.

Subsection 110.1(5) of the Act is amended to clarify that such amount will also be, subject to the designation of an amount under subsection 110.1(3), the corporate donor's proceeds of disposition for the purposes of calculating income and capital gains. This amendment applies in respect of gifts made after February 27, 1995.

Subsection 110.1(5) is also amended, concurrently with paragraph 110.1(1)(*d*) of the Act, to provide that the fair market value of ecologically sensitive land (including a covenant, an easement or a servitude) and, consequentially, the corporate donor's proceeds of disposition, is deemed to be the amount determined by the Minister of the Environment. This amendment applies to gifts made after February 27, 2000.

Administrative measures regarding the request for a determination of fair market value from the Minister of the Environment, including notification, determination and redetermination, are included in new subsections 118.1(10.2) to (10.5) of the Act. Consequential assessments of tax are provided for in amended subsection 118.1(11) of the Act. Appeals to the Tax Court of Canada are provided for in new subsection 169(1.1) of the Act.

## Clause 86

## Lifetime Capital Gains Exemption

ITA
110.6

Section 110.6 of the Act sets out the rules that apply in calculating an individual's entitlement to the lifetime capital gains exemption.

ITA
110.6(1)

"investment expense"

Section 110.6 of the Act sets out the rules for calculating an individual's entitlement to the lifetime capital gains exemption. An individual's "investment expense" for a taxation year can result in a lower "cumulative gains limit", and can thereby reduce the individual's entitlement to a deduction under section 110.6. As a consequence of the application of subparagraph (*a*)(ii) and paragraph (*d*) of the definition "investment expense" in subsection 110.6(1), 50% of foreign exploration and development expenses deducted under subsection 66(4) in computing an individual's income for a taxation year is added in computing the individual's investment expense for the year in the event that the individual is a "specified member" of the partnership (as defined in subsection 248(1)).

Subparagraph (*a*)(ii) and paragraph (*d*) of the definition "investment expense" are amended to extend this treatment of foreign exploration and development expenses to foreign resource expenses, as a consequence of the introduction of section 66.21.

These amendments apply to taxation years that begin after 2000.

## Capital Gains Deduction – Qualified Farm Property

ITA
110.6(2)

Subsection 110.6(2) of the Act provides a deduction from income in computing the taxable income of taxpayer in respect of taxable capital gains from the disposition of qualified farm property.

Paragraph 110.6(2)(*a*) determines the unused portion of an individual's lifetime capital gains exemption limit in respect of capital gains realized on dispositions of qualified farm property. The paragraph is amended as a consequence of the reduction of the inclusion rate for capital gains from 3/4 to 1/2, and applies to taxation years that end after February 27, 2000.

Amended subsection 110.6(2)(*a*)

- decreases the lifetime taxable capital gains exemption limit from $375,000 to $250,000 to reflect the reduction of the inclusion rate for capital gains from 3/4 to 1/2,
- reduces the limit by the deductions claimed in prior years that ended before 1988, when the taxable capital gains inclusion rate was 1/2,
- reduces the limit by 3/4 of the deductions claimed in prior years that ended after 1987 and before 1990, and for taxation years that began after February 27, 2000 and ended before October 18, 2000 when the inclusion rate for capital gains was 2/3,
- reduces the limit by 2/3 of the deductions claimed in taxation years that ended after 1989 and before February 27, 2000, when the inclusion rate for capital gains was 3/4,
- reduces the limit by 2/3 of the deductions claimed in taxation years that ended after 1987 and before 1990 in respect of amounts included in income under subparagraph 14(1)(*a*)(v) of the Act when the inclusion rate was 3/4, and
- reduces the limit by the product obtained by multiplying the deductions claimed by the individual in the 2000 taxation year by the reciprocal of the fraction obtained for the year under new variable E.

New variable E in the formula is added to reflect the inclusion rate applicable to the individual for the 2000 taxation year. The variable adjusts for the situation where the capital gains inclusion rate under paragraph 38(*a*) in respect of capital gains is different than the one used under subsection 14(1.1) in respect of gains arising on a disposition of eligible capital property used in a farming business. New variable E is determined by doubling the fraction obtained when the taxable capital gain for the year 2000 (including the deemed taxable gain determined under subsection 14(1.1)) is divided by net capital gains (not the taxable) for the year. The formula in variable E will, among other things, adjust the taxable gain determined under subsection 14(1.1) to reflect the gross gain.

*Example 1*

Assume

Paul has in prior taxation years reported the following:

| Taxation year | Capital gain from the disposition of qualified farm property | Amount deducted under subsection 110.6(2) |
|---|---|---|
| 1985 | $50,000 | $25,000 |
| 1988 | $100,000 | $66,667 |
| 1991 | $100,000 | $75,000 |

*No other amounts have been deducted by Paul under section 110.6.*

*In January, 2000, Paul realizes a $300,000 capital gain from the disposition of qualified farm property. The fraction required to be used by Paul under amended paragraph 38(a) for his 2000 taxation year is 3/4. What amount can be deducted by Paul under subsection 110.6(2) for his 2000 taxation year assuming paragraph 110.6(2)(a) applies?*

*Determination*

*Paragraph 110.6(2)(a) requires Paul to determine an amount using the formula [$250,000-(A+B+C+D)] x E.*

*Because Paul's 2000 taxation year includes either February 28, 2000 or October 17, 2000, amended paragraph 110.6(2)(a) requires Paul to multiply the amount determined by the formula by 1.5 (i.e., twice the fraction that applies for the year: 3/4 x 2).*

*The amount of the unused deduction limit determined by the formula equals $187,500 since*

*A = $25,000,*
*B = $50,000 (i.e., 3/4 66,667),*
*C = $50,000 (i.e., 2/3 x $75,000),*
*D = $0, and*
*E = 1.5 [i.e., 2 x ($225,000/$300,000)]*

***Example 2***

*Heather realized a $400,000 capital gain in her 2000 taxation year from the disposition of qualified farm property and deducted $300,000 in respect of that gain under section 110.6. The fraction in paragraph 38(a) that was applicable to Heather for her 2000 taxation year was 3/4. In 2001, Heather realizes a $100,000 capital gain from the disposition of another qualified farm property. Heather has not realized any other capital gains. How much is she entitled to deduct under subsection 110.6(2) assuming paragraph 110.6(2)(a) applies?*

*Determination*

*Paragraph 110.6(2)(a) requires Heather to determine an amount using the formula [$250,000-(A+B+C+D)] x E*

*The amount determined by the formula equals $50,000 since*

*A = $0,*
*B = $0,*
*C = $0,*
*D = $200,000 (1/1.5 x $300,000), and*
*E = 1.*

The deductions permitted under section 110.6 for Heather's 2000 and 2001 taxation years allow her to claim deductions in respect of taxable capital gains derived from $500,000 of capital gains realized from the disposition of qualified farm property.

## Capital Gains Deduction – Qualified Small Business Corporation Shares

ITA
110.6(2.1)

Subsection 110.6(2.1) of the Act provides a deduction in computing the taxable income of taxpayer in respect of taxable capital gains from the disposition of qualified small business corporation shares.

Paragraph 110.6(2.1)(*a*) is amended as a consequence of the reduction of the inclusion rate for capital gains from 3/4 to 1/2, and applies to taxation years that end after February 27, 2000. Amended subsection 110.6(2.1)(*a*) refers to the amount referred to in proposed new paragraph 110.6(2)(*a*).

### Maximum Capital Gains Deduction

ITA
110.6(4)

Subsection 110.6(4) of the Act provides an overall lifetime taxable capital gains exemption limit for an individual.

The subsection is amended to adopt the limit provided for in paragraph 110.6(2)(*a*). Under that paragraph, the individual is limited to $250,000 of deductions in respect of taxable capital gains – which is determined by multiplying $500,000 of capital gains by the one-half inclusion rate for capital gains.

The amendment to subsection 110.6(4) is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2. It is effective for taxation years that end after February 27, 2000.

### Spousal or Common-Law Partner Trust Deduction

ITA
110.6(12)

Subsection 110.6(12) of the Act generally provides for a deduction, in computing the taxable income of a trust for the benefit of a spouse or common-law partner for the year of the trust in which the spouse or common-law partner dies, of an amount equal to the lesser of the unused lifetime capital gains exemption limit of the deceased and the amount of the taxable gains of the trust determined under that subsection.

Subsection 110.6(12) is amended to ensure that it does not apply to *alter ego* trusts or joint spousal or common-law partner trusts (as newly defined in subsection 248(1)). This amendment is consequential to the extension of paragraph 104(4)(*a*) to provide for deemed dispositions for *alter ego* trusts and joint spousal or common-law partner trusts. This amendment applies to the 2000 and subsequent taxation years.

Paragraph 110.6(12)(*c*) is also amended to adopt the limit provided for in paragraph 110.6(2)(*a*) in respect of the deceased spouse or common-law partner for the year of death, minus any amounts deducted by that person for the year of death.

This amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2 and applies to taxation years that end after February 27, 2000, except that the amount determined under amended paragraph 110.6(12)(*c*) in computing a trust's taxable income for a taxation year that includes either February 28, 2000 or October 17, 2000 is to equal the amount determined under that paragraph multiplied by the quotient obtained when the fraction in amended paragraph 38(*a*) of the Act that applies to the trust for its taxation year is divided by the fraction in amended paragraph 38(*a*) that applies to the taxpayer's spouse or common-law partner for the taxation year in which the spouse or common-law partner died. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Clause 87

### Loss Carryovers

ITA
111

Section 111 of the Act establishes the extent to which a taxpayer is permitted to deduct, in computing taxable income for a taxation year, losses of other years.

### Carryforward of Limited Partnership Losses

ITA
111(1)(*e*)(ii)(C)(I)

To the extent provided by paragraph 111(1)(*e*), limited partnership losses (as defined in subsection 96(2.1)) for a taxation year in respect of a partnership may be carried forward for deduction in computing taxable income for a subsequent taxation year. The potential deduction in respect of a partnership is reduced to reflect the amount by which the taxpayer's "at-risk amount" in respect of the partnership exceeds the taxpayer's shares of specified resource expenditures (including foreign exploration and development expenses) incurred by the partnership.

Subclause 111(1)(*e*)(ii)(C)(I) is amended so that "foreign resource pool expenses", as newly defined in subsection 248(1), are referred to instead of foreign exploration and development expenses. The new definition includes expenses that are a foreign resource expense, as defined in new section 66.21, in addition to foreign exploration and development expenses.

This amendment applies to taxation years that begin after 2000.

## Definitions

ITA
111(8)

Subsection 111(8) of the Act contains definitions that apply for the purposes of section 111. Two of these definitions – "non-capital loss" and "pre-1986 capital loss balance" – are amended.

"non-capital loss"

The definition "non-capital loss", which takes the form of a formula, is amended in two ways.

First, it is amended to include, in an individual taxpayer's non-capital losses, amounts deducted by the taxpayer under new paragraph 110(1)(*d*.01) of the Act. That paragraph allows a deduction where certain employee option securities (or proceeds from the disposition of such securities) are donated to a qualifying charity. This amendment – which is made by modifying the description of E in the description of A in the definition – applies to the 2000 and subsequent years.

Second, the definition is amended to include, in a corporate taxpayer's non-capital losses, amounts determined under new subparagraph 115(1)(*a*)(vii) of the Act. That subparagraph, which applies to authorized foreign banks, replicates the effect of section 110.5 of the Act which is to permit a corporation to increase its taxable income in order to increase its foreign tax credit. This amendment – which is made by modifying the description of B in the definition – applies after June 27, 1999.

"pre-1986 capital loss balance"

An individual's "pre-1986 capital loss balance" for a taxation year is relevant for the purposes of paragraph 111(1.1)(*b*) of the Act and represents the individual's unused pre-1986 capital losses that the individual can deduct, up to $2000 per year, from income other than capital gains of the individual.

The definition is amended as a consequence of the reduction of the inclusion rate for capital gains, applicable to taxation years that end after February 27, 2000.

The description of C in the formula is amended to provide for the deduction from the pre-1986 net capital losses of the section 110.6 deductions claimed by the individual in respect of taxable capital gains realized in taxation years that ended before 1988 or begin after October 17, 2000, when the inclusion rate for capital gains was also 1/2.

Under the current definition, because of the description of D in the formula, pre-1986 capital losses are reduced by 3/4 of the deductions claimed under section 110.6 of the Act for taxation years that ended after 1987 and before 1990. This description reflects the fact that the inclusion rate for those years was 2/3 rather than the 1/2-rate used for years prior to 1986 when the pre-1986 net capital losses were accumulated. The description of D in the formula is amended to provide for the deduction from the pre-1986 net capital losses of 3/4 of the section 110.6 deductions claimed by the individual in respect of taxable capital gains realized in taxation years that ended after 1987 and before 1990 or began after February 27, 2000 and ended before October 18, 2000, when the inclusion rate for capital gains was 2/3 rather than the 1/2 used for years prior to 1986 when the pre-1986 net capital losses were accumulated.

The description of E in the formula is amended to provide for the deduction from the pre-1986 net capital losses of 2/3 of the section 110.6 deductions claimed by the individual in respect of taxable capital gains realized in taxation years that ended after 1989 and before February 28, 2000, when the inclusion rate for capital gains was 3/4 rather than the 1/2 used for years prior to 1986 when the pre-1986 net capital losses were accumulated.

The description of E.1 in the formula provides for the deduction from the pre-1986 net capital losses of amounts in respect of deductions claimed under section 110.6 in the 2000 taxation year of the individual that includes either February 28, 2000 or October 17, 2000. The deduction is the product obtained by multiplying the total amounts of the individual's deductions claimed for the year by the fraction obtained by dividing 1/2 by the fraction in paragraph 38(*a*) that applies to the individual for the year.

These amendments apply to taxation years that end after February 27, 2000.

## Losses – Non-resident

ITA
111(9)

Subsection 111(9) of the Act sets out special limits that apply to carryovers from taxation years during which a taxpayer is not resident in Canada.

Subsection 111(9) is amended, for the 1998 and subsequent taxation years, as a consequence of changes to section 114 of the Act. The amendment replaces a reference to the portion of the year referred to in paragraph 114(*b*) with a reference to the part of the year throughout which the taxpayer was non-resident. This keeps the reference in step with the changes to section 114. For additional information, see the commentary on section 114.

## Clause 88

### Dividends Received by a Corporation Resident in Canada

ITA
112

Section 112 of the Act deals with the treatment of dividends received by a corporation resident in Canada from another corporation.

### Guaranteed Shares

ITA
112(2.2)

Subsection 112(2.2) of the Act denies the intercorporate dividend deduction for dividends on certain shares that are guaranteed by a specified financial institution. This subsection is amended by dividing its provisions among three new subsections – (2.2), (2.21) and (2.22) – in order to improve readability. In addition, a new exception is set out in new paragraph 112(2.21)(*d*), described below.

Amended subsection (2.2) sets out the basic conditions under which a share is considered to be a guaranteed share.

These amendments apply to dividends received after 1998.

### Exceptions

ITA
112(2.21)

New subsection 112(2.21) of the Act sets out exceptions specifying shares to which the guaranteed share rule in amended subsection 112(2.2) does not apply. Paragraphs 112(2.21)(*a*) to (*c*) set out the exceptions formerly contained in paragraphs 112(2)(*c*) to (*e*).

Paragraph 112(2.21)(*d*) sets out a new exception for certain shares held within a corporate group. The exception applies where two general conditions are met. First, the shares must not have been acquired by the holder in the ordinary course of its business, and the guarantee agreement must not have been given in the ordinary course of business of the party that gave it. Second, the issuer of the share must be related to both the holder and the guarantor, otherwise than because of an option or other right referred to in paragraph 251(5)(*b*) of the Act.

This subsection applies to dividends received after 1998.

### Interpretation

ITA
112(2.22)

New subsection 112(2.22) of the Act sets out rules of interpretation that apply to the guaranteed share rules in subsections (2.2) and (2.21). These provisions were formerly contained in paragraphs 112(2.2)(*f*) and (*g*). This new subsection applies to dividends received after 1998.

### Loss on Share Held by Trust

ITA
112(3.2) and (3.3)

Subsections 112(3.2) and (3.3) of the Act provide rules for the determination of a loss of a trust from a disposition of a share where the trust has received taxable dividends and capital dividends on the share.

The amendments to these subsections, which apply to dispositions that occur after February 27, 2000, replace the reference to the fraction "1/4" with a reference to the fraction "1/2" and are consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

## Clause 89

### Part-Year Residents

ITA
114 and 114.1

Section 114 of the Act provides rules for computing the taxable income of an individual (often referred to as a "part-year resident") who is resident in Canada for some period or periods in a taxation year, and is non-resident for the rest of the year.

In its current form, section 114 in effect applies a two-stage computation. First, it adds the individual's income for the resident part of the year and the individual's taxable income earned in Canada (a term defined in subsection 115(1) of the Act) for the non-resident part of the year, in each case as though the part were the whole year. Second, it allows those deductions (or parts of deductions) in computing taxable income that can reasonably be considered to apply to the resident part of the year.[12]

This division of the year into separate parts can produce unclear and perhaps inconsistent effects. For example, assume that an individual who emigrates from Canada on June 30 holds shares of a Canadian company that are not listed on a prescribed exchange, with an adjusted cost base of $100 and a fair market value of $160 on emigration. Under proposed amendments to section 128.1 of the Act, the individual is treated as having disposed of the shares and realized the $60 accrued gain before ceasing to be resident in Canada, and as having reacquired the shares, as a non-resident, at a cost of $160. Assume further that the individual actually disposes of the shares on September 30 of the same year, for $140.

On these facts, the individual has a gain of $60 in the resident part of the year, and a loss of $20 in the non-resident part. The result is an overall gain of $40, assuming that the post-departure loss can offset the pre-departure gain. However, the separate calculation under section 114 of the resident-period income and the non-resident period taxable income earned in Canada makes it uncertain that the two can be offset in this way.

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[12] Deductions are not provided for the non-resident part of the year because they are already taken into account in computing taxable income earned in Canada.

Section 114 is amended to avoid such uncertainties, as well as to simplify the application of the rule. The starting-point for calculating a part-year resident's taxable income under amended section 114 is, in paragraph 114(*a*), the individual's income for the year, counting only those amounts of income and losses for the non-resident period that are included in computing taxable income earned in Canada under paragraphs 115(1)(*a*) to (*c*) of the Act.

Paragraphs 114(*b*) and (*c*) set out the deductions that the part-year resident may take in computing taxable income. Paragraph 114(*b*) allows the deduction of loss carryovers permitted by subsection 111(1) of the Act. It also allows the deductions permitted by paragraphs 110(1)(*d*), (*d*.1) and (*d*.2) (the non-taxable 1/4 of employee stock option and prospector's and grubstaker's share benefits) and paragraph 110(1)(*f*) (various social benefits, amounts exempt from Canadian tax under a tax treaty, and income from employment with certain international organizations), to the extent these relate to amounts that have been included in computing the paragraph 114(*a*) amount. Paragraph 114(*c*) allows any other deduction that the Act permits in computing taxable income. A deduction under paragraph 114(*c*) is allowed to the extent the deduction either can reasonably be considered to be applicable to the resident period or, if all or substantially all of the individual's income for the non-resident period is included in the paragraph 114(*a*) amount, can reasonably be considered to apply to the non-resident period.

In the example described above, amended section 114 will include both the resident-period gain and the non-resident-period loss in computing the single paragraph 114(*a*) income amount. The part-year resident will thus be treated as having realized a gain of $40 for the year as a whole.

Amended section 114 applies to the 1998 and subsequent taxation years. A number of consequential amendments ensure that these changes are reflected in other provisions of the Act that refer to section 114.

Section 114.1 of the Act is a technical rule that applies a special reading of paragraphs 115(2)(*b*), (*b*.1) and (*c*) of the Act, for the purpose of applying section 114, to ensure that certain time references in those paragraphs accommodate cases to which section 114 applies. With the restructuring of section 114, this rule is no longer needed. Section 114.1 is repealed for the 1998 and subsequent taxation years.

## Clause 90

### Non-Resident's Taxable Income in Canada

ITA
115

Section 115 of the Act determines the amount of a non-resident person's income that is subject to tax under Part I of the Act. This amount is referred to as the non-resident's "taxable income earned in Canada".

### Taxable Income Earned in Canada by Non–Residents

ITA
115(1)

Subsection 115(1) of the Act provides the general rules to be applied in calculating a non-resident's "taxable income earned in Canada". Paragraphs 115(1)(*a*) to (*c*) describe the conditions that apply in computing a non-resident's taxable income earned in Canada, while paragraphs 115(1)(*d*) to (*f*) describe the deductions that are available for the purpose of that computation.

Paragraphs 115(1)(*a*) to (*c*) set out special assumptions that are applied in computing the taxable income earned in Canada of a non-resident taxpayer. The general effect of these paragraphs, in conjunction with the deduction provided for treaty-protected income because of the reference to paragraph 110(1)(*f*) in paragraph 115(1)(*d*), is to include in this computation only income and losses from sources in Canada, and of those only amounts that are not treaty-protected.

ITA
115(1)(*a*)

Subparagraph 115(1)(*a*)(i) includes in this computation income from the duties of offices and employments that the non-resident person in Canada performs in Canada. Subparagraph 115(1)(*a*)(i) is amended to include as well income from offices and employments performed by the non-resident person outside of Canada, if the person was resident in Canada at the time the duties were performed. This ensures that if an individual who is a former resident of Canada receives, as a non-resident, income relating to work the individual performed outside Canada at a time when the individual was resident in Canada, the income is subject to Canadian tax.

This amendment generally applies to the 1998 and subsequent taxation years. In addition, if an individual ceased to be resident in Canada after 1992 and before October 2, 1996, and the individual so elects, this amendment applies to income received by the individual after that cessation of residence. The election in effect backdates the explicit exclusion of certain income rights and trust interests from the deemed disposition immediately before emigration. The basis for excluding the rights in question from the deemed disposition is that they generally represent entitlements to future income that will itself be subject to Canadian tax when it is received by a non-resident. Linking the application of amended subparagraph 115(1)(*a*)(i) to the election ensures that the Act does tax that income, where it relates to employment exercised abroad by a resident of Canada.

Subparagraph 115(1)(*a*)(ii) includes in the computation of taxable income earned in Canada income from businesses carried on by the non-resident person in Canada. The amendment to this provision specifies that in the case of the Canadian banking business of an authorized foreign bank (both expressions newly defined in subsection 248(1) of the Act), the starting point for the computation of the income from the business is the profit computed using the bank's branch financial statements (as defined in new subsection 20.2(1) of the Act), which are those required to be filed with the Superintendent of Financial Institutions. Reliance on the branch financial statements ensures that the scope of the Canadian banking business and its transactions are defined consistently for regulatory and tax purposes. Profit computed using the branch financial statements is, however, subject to adjustment under the rules in Part I of the Act in determining income for tax purposes.

This amendment applies after June 27, 1999.

Paragraph 115(1)(*a*) is also amended to add new subparagraph (vii), which includes in the taxable income earned in Canada of an authorized foreign bank the amount claimed by the bank to the extent that the inclusion increases the bank's usable foreign tax credit under subsection 126(1) but does not increase any amount deductible by the bank under section 127 of the Act. This addition to taxable income earned in Canada parallels the addition to taxable income that is available to corporations resident in Canada under existing section 110.5 of the Act.

New subparagraph 115(1)(*a*)(vii) applies after June 27, 1999.

ITA
115(1)(*b*), (*b*.1)

Paragraph 115(1)(*b*) lists the types of property (called "taxable Canadian property" or TCP) in respect of which taxable gains and allowable capital losses are considered in the calculation of a non-resident's taxable income earned in Canada. As a result of the relocation of the general TCP definition to subsection 248(1) of the Act, paragraph 115(1)(*b*) can be greatly simplified. In its new form, the paragraph simply refers to taxable capital gains and allowable capital losses on TCP that is not "treaty-protected property" (as defined in subsection 248(1) of the Act).

Paragraph 115(1)(*b*.1) excludes from the computation of a non-resident's taxable income earned in Canada any taxable capital gain or allowable capital loss from the disposition of a taxable Canadian property that was treaty-protected property of the non-resident. Since this exclusion now forms part of amended paragraph 115(1)(*b*), paragraph 115(1)(*b*.1) can be repealed.

Amended paragraph 115(1)(*b*) generally applies after October 1, 1996. Since the definition (and the concept) of "treaty-protected property" was introduced only with the 1998 Budget, and applies for the 1998 and later taxation years, a transitional version of amended paragraph 115(1)(*b*) omits the reference to treaty-protected property for dispositions that occur before the 1998 taxation year.

ITA
115(1)(*d*)

Paragraph 115(1)(*d*) allows certain deductions under subsections 110(1), 110.1(1) and 111(1) of the Act to be taken into account in determining the amount of a non-resident person's income that is subject to tax under Part I of the Act.

Paragraph 115(1)(*d*) is amended to allow a deduction under new paragraph 110(1)(*d*.01) to be taken into account. Paragraph 110(1)(*d*.01) allows a deduction where certain employee option securities (or proceeds from the disposition of such securities) are donated to a qualifying charity. The deduction may be taken into account to the extent that the securities option benefit to which the deduction relates is included in computing the amount of the non-resident person's income that is subject to tax under Part I of the Act.

This amendment applies to the 2000 and subsequent taxation years.

ITA
115(1)(*e*.1)

Paragraph 115(1)(*e*.1) of the Act is introduced to allow the deduction provided under subsection 115(4.1) in computing a non-resident's taxable income earned in Canada.

This amendment applies to taxation years that begin after February 27, 2000.

**Persons Deemed Employed in Canada**

ITA
115(2)

Subsection 115(2) applies, in certain special circumstances, to tax remuneration and specified other amounts received by a non-resident. Because of paragraphs 115(2)(*b*) and (*b*.1), subsection 115(2) applies to post-secondary students at Canadian institutions and former Canadian residents who have moved abroad to carry out research or similar work under a grant. The paragraphs are amended, with application to the 1998 and subsequent taxation years, to update their language to reflect current drafting styles. The amendments make no substantive change to the paragraphs.

## Non-Resident Actors

ITA
115(2.1)

New subsection 115(2.1) of the Act is added as a result of the addition of a new withholding tax in new subsection 212(5.1) of the Act, which applies to non-resident film and video actors and corporations related to them. Under new subsection 212(5.1), a non-resident person (either the individual actor or a related corporation) will be subject to a 23% withholding tax on amounts received for acting services rendered in Canada, unless the non-resident person files a Part I return and chooses, under new section 216.1 of the Act, to include in computing taxable income earned in Canada the amount received for acting services. For more information on these new rules, readers may refer to the notes to new subsection 212(5.1).

In the event that an actor or a corporation does not elect to include the amounts received for acting services in computing income under Part I of the Act but has other taxable income earned in Canada that is subject to Part I tax, new subsection (2.1) ensures that the acting services amount is not included as part of taxable income earned in Canada.

New subsection 115(2.1) applies to amounts paid, credited or provided after 2000.

## Deferred Payment by Actor's Corporation

ITA
115(2.2)

New subsection 115(2.2) of the Act applies to amounts paid, credited or provided as a benefit by a corporation to a non-resident actor for acting services rendered in Canada.

This new subsection applies if a corporation has received a payment for acting services and 23% of the amount has been withheld and remitted, in accordance with new subsection 212(5.1) of the Act. If the corporation, in a subsequent year, makes a payment to the actor, then under section 115 this payment is not deductible by the corporation in computing the corporation's income for any year. The amount is also not included in the taxable income earned in Canada of the actor for any year. For more information on these new rules, readers may refer to the notes to new subsection 212(5.1).

New subsection 115(2.2) applies in respect of amounts paid, credited or provided after 2000.

## Interests or Options in Property

ITA
115(3)

Subsection 115(3) of the Act provides that, for the purposes of section 115 of the Act, taxable Canadian property includes an interest in, or an option in respect of, a property, regardless of whether or not the property is in existence. Because the definition "taxable Canadian property" has been moved from subsection 115(1) to subsection 248(1) of the Act, and the new definition contains in paragraph (*l*) a similar rule for interests and options, subsection 115(3) is no longer needed and is repealed, effective after October 1, 1996.

## Foreign Resource Pool Expenses

ITA
115(4.1)

Notwithstanding that a non-resident taxpayer is precluded under subsections 66(4) and 66.21(4) of the Act from claiming deductions for foreign exploration and development expenses (FEDE) and foreign resource expenses (FRE) in computing income, new subsection 115(4.1) permits a non-resident taxpayer (who ceased to be resident in Canada after February 27, 2000) to claim a deduction in computing taxable income earned in Canada with reference to the rules in those subsections. The amount so claimed by a taxpayer is based on the taxpayer's unused FEDE and FRE balances immediately after ceasing to reside in Canada. The claim for the first taxation year of non-residence cannot exceed 10% of that balance, and does not depend on the level of related foreign resource income. The 10% limit also applies to subsequent taxation years, but is determined with reference to those balances (computed net of relevant deductions previously claimed under subsection 115(4.1)).

This amendment applies to taxation years that begin after February 27, 2000.

## Clause 91

### Disposition of Certain Property by Non-Resident

ITA
116

Section 116 of the Act establishes procedures for collecting tax from non-residents on the disposition of taxable Canadian property, Canadian resource properties, and certain other properties.

ITA
116(1), (5.1) and (5.2)

Where a non-resident plans to dispose of property the proceeds from the disposition of which are subject to Canadian tax, the non-resident can obtain a "clearance certificate" from the Minister of National Revenue. The certificate, which is provided as well to the prospective purchaser, verifies that the non-resident vendor has made arrangements for the payment of any resulting tax. Without such a certificate, the purchaser may be required to remit a portion of the purchase price to the Receiver General.

Subsections 116(1), (5.1) and (5.2) set out some of the rules and procedures for this process. These subsections are amended, with application after October 1, 1996, to reflect the amended definition "taxable Canadian property" in subsection 248(1) of the Act. In particular, that amended definition clarifies that a property's status as taxable Canadian property does not depend on its being disposed of – this allows the references in these subsections to be simplified.

ITA
116(2), (4) and (5)

Section 116 of the Act provides for the issuance of a certificate for non-residents disposing of taxable Canadian property. In order to receive the certificate, an amount equal to 33 1/3% of the anticipated gain must be paid by the non-resident on account of income taxes that may become payable as a result of the disposition. This amount is based on the tax rate and the capital gains inclusion rate.

These subsections are amended to replace the reference to the percentage "33 1/3%" with a reference to the percentage "25%", consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

These amendments apply to taxation years that end after February 27, 2000 except that, for a taxation year that ends after February 27, 2000 and before October 18, 2000, the reference to the percentage "25%" is to be read as reference to the percentage "30%". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Definition of "Excluded Property"

ITA
116(6)

The various rules in section 116 of the Act, which provides a withholding procedure for purchasers of certain properties, do not apply where the property is excluded property. "Excluded property" is defined in subsection 116(6).

Paragraph 116(6)(*a*) provides that any property referred to in subparagraph 115(1)(*b*)(xii) of the Act (property that is deemed by a provision of the Act to be taxable Canadian property) is excluded property. Due to the amended definition "taxable Canadian property" in subsection 248(1) of the Act, paragraph 116(6)(*a*) is amended, effective after October 1, 1996, to remove the reference to subparagraph 115(1)(*b*)(xii), and to provide that a property is excluded property if it is a taxable Canadian property solely because it is deemed to be so by a provision of the Act.

New paragraph 116(6)(*a*.1) provides that property described in an inventory of a business carried on in Canada is excluded property for the purposes of section 116 of the Act. This new provision is a result of the change to paragraph (*b*) of the definition "taxable Canadian property" in subsection 248(1), which now includes as taxable Canadian property the inventory of a business carried on in Canada. Effective after October 1, 1996, new paragraph 116(6)(*a*.1) excludes such inventory from the requirements of section 116. However, the exclusion does not apply to inventory that is real property situated in Canada, a Canadian resource property or a timber resource property.

Paragraph 116(6)(*b*) provides that a share of a class of a corporation's capital stock, or an interest in a share, will be excluded property for the purposes of section 116 if that class of shares is listed on a prescribed stock exchange. This paragraph is amended to remove the reference to an interest in such a share, which is covered by new paragraph 116(6)(*h*).

Paragraph 116(6)(*e*) is amended to remove the reference to property prescribed to be excluded property. At the same time, the various types of excluded property currently prescribed by section 810 of the *Income Tax Regulations* are moved to subsection 116(6) and a new provision is added dealing with Canadian branches of foreign banks:

- paragraph 116(6)(*e*) includes property of licensed non-resident insurers that carry on business in Canada;

- new paragraph 116(6)(*f*) includes property of an authorized foreign bank that is used or held in the course of the bank's Canadian banking business;

- new paragraph 116(6)(*g*) includes an option in respect of property referred to in any of paragraphs 116(6)(*a*) to (*f*); and

- new paragraph 116(6)(*h*) includes an interest in property referred to in any of paragraphs 116(6)(*a*) to (*g*).

These amendments apply after June 27, 1999.

## Clause 92

### Tax Rates for Individuals

ITA
117

Section 117 of the Act sets out the tax rates for individuals.

ITA
117(2)

Subsection 117(2) of the Act provides the marginal tax rates of federal tax. These amendments provide two tax rate structures: one for 2000 and the other for the 2001 and subsequent taxation years.

The 2000 tax structure is as follows:

- 17 per cent of taxable income up to $30,004
- 25 per cent of taxable income between $30,004 and $60,009
- 29 per cent of taxable income that exceeds $60,009.

The tax structure for 2001 and subsequent years is as follows:

- 16 per cent of taxable income up to $30,754
- 22 per cent of taxable income between $30,754 and $61,509
- 26 per cent of taxable income between $61,509 and $100,000
- 29 per cent of taxable income that exceeds $100,000.

ITA
117(3)

New subsection 117(3) of the Act provides that the income thresholds of $30,754, $61,509 and $100,000 used in computing an individual's tax for the 2004 taxation year will not be less than $35,000, $70,000 and $113,804, respectively, regardless of the annual increase provided under the indexing provisions of the Act.

This amendment applies to the 2004 taxation year.

## Clause 93

### Personal Tax Credits

ITA
118

Section 118 of the Act provides for the calculation of various personal tax credits.

### Personal Credits – In-Home Care of Relatives

ITA
118(1)B(*c*.1)

Paragraph (*c*.1) of the description of B in section 118(1) of the Act provides a tax credit to an individual who provides in-home care for an adult relative. The relative in respect of whom the credit may be claimed has to be the individual's child, grandchild, parent, grandparent, brother, sister, aunt, uncle, nephew or niece. The paragraph is amended to also allow a taxpayer to claim the caregiver tax credit in respect of such relatives of the taxpayer's spouse or common-law partner.

This amendment applies to the 1998 and subsequent taxation years.

This paragraph is also amended to reflect changes effected by the *Modernization of Benefits and Obligations Act*.

### Infirm Dependant Tax Credit

ITA
118(1)B(*d*)

Paragraph (*d*) of the description of B in subsection 118(1) of the Act provides a tax credit to an individual who supports an infirm dependent relative. This paragraph is amended to increase the amount on which the credit is computed to $3,500 from $2,446.

This amendment applies to the 2001 and subsequent taxation years.

### Minimum Amounts for 2004

ITA
118(3.1)

New subsection 118(3.1) of the Act provides that the amounts of $7,131, $6,055 and $606, which are used in computing an individual's basic tax credit and the tax credit that may be claimed by the individual, in respect of a spouse, a common-law partner or, in some circumstances, a wholly dependent person will not, for the 2004 taxation year, be less than $8,000, $6,800 and $680, respectively, regardless of the annual increase provided under the indexing provisions of the Act.

This amendment applies to the 2004 taxation year.

## Clause 94

### Charitable Donations Tax Credit

ITA
118.1

Section 118.1 of the Act provides for a charitable donations tax credit that may be claimed by individuals who make charitable donations, gifts to the Crown and certain gifts of cultural property and ecologically sensitive land. Donors may carry forward unused claims for up to five years.

### Definitions

ITA
118.1(1)

"total ecological gifts"

Subsection 118.1(3) of the Act provides for a tax credit in respect of gifts made by individuals to registered charities and certain other entities. Unlike most charitable gifts, the eligible value of qualified ecological gifts is not subject to an annual 75% income limit. An ecological gift is defined in subsection 118.1(1) as a gift of land (including a covenant, an easement or a servitude) that is certified by the Minister of the Environment to be ecologically sensitive land, the conservation and protection of which is, in the opinion of that Minister, important to the preservation of Canada's environmental heritage. The beneficiary must be the federal government, a provincial or territorial government, a municipality or a registered charity approved by the Minister of the Environment.

The definition "total ecological gifts" in subsection 118.1(1) is amended to require that the fair market value of the gift be certified by the Minister of the Environment. The fair market value is relevant to the calculation of the tax credit available to the individual under subsection 118.1(3) and of the taxable capital gain under section 38.

This amendment applies to gifts made after February 27, 2000.

### Proof of Gift

ITA
118.1(2)

Subsection 118.1(2) of the Act provides that no deduction may be made in respect of a charitable donation or a gift to the Crown unless the gift is evidenced by a receipt containing prescribed information. The subsection is amended to clarify that, in the case of a gift of cultural property or an ecological gift, certificates issued by the Cultural Property Export Review Board or the Minister of the Environment must also be submitted.

This amendment applies to gifts made after February 27, 2000, except that the amendment in respect of cultural property does not apply to gifts made before December 21, 2000.

### Gift in the Year of Death

ITA
118.1(4)

Subsection 118.1(4) of the Act provides a special rule in the case of gifts that are made by an individual in the taxation year in which the individual dies. Under that subsection, a gift made by the individual in that year is generally considered to have been made in the individual's preceding taxation year, to the extent that the charitable donations tax credit in respect of the amount of the gift is not deducted in computing the individual's tax for the year of death. The gifts of a deceased individual to which subsection 118.1(4) applies include those otherwise deemed by specified provisions in section 118.1 to be gifts made immediately before the individual died.

Subsection 118.1(4) is amended so that new subsections 118.1(5.2) and (5.3) are included among the specified provisions. In general terms, these subsections deal with cases where a charity is a beneficiary under a life insurance policy or under a registered retirement savings plan or registered retirement income fund. As a consequence of the amendment to subsection 118.1(4), gifts deemed by subsection 118.1(5.2) or (5.3) to have been made by an individual immediately before the individual's death can result in a reduction in the individual's tax for the taxation year preceding the taxation year of the individual's death.

This amendment applies to deaths that occur after 1998.

Subsection 118.1(4) is also amended consequential to the amendment of subsections 118.1(7) and (7.1) of the Act, to clarify that it applies for the purposes of those subsections. For further information, see the commentary to those subsections.

This amendment generally applies to the 2000 and subsequent taxation years.

## Direct Designation – Insurance Proceeds

ITA
118.1(5.1) and (5.2)

New subsection 118.1(5.2) of the Act, in conjunction with new subsection 118.1(5.1), extends the charitable donations tax credit to eligible transfers under a life insurance policy that are made as a consequence of designations under the policy. As a result, the charitable donations tax credit can be claimed on an individual's death as a consequence of qualifying transfers to qualified donees under life insurance policies that insure the individual's life. Each of the conditions set out in paragraphs 118.1(5.1)(*a*) to (*d*) must be satisfied for this result to apply.

Paragraph 118.1(5.1)(*a*) requires the policy to be a life insurance policy in Canada (as defined by subsection 138(12)) under which, immediately before the individual's death, the individual's life was insured. The policy could include a group life insurance policy, an annuity or a segregated fund policy.

Paragraph 118.1(5.1)(*b*) requires that, as a consequence of the individual's death, an eligible transfer of money (or a transfer by means of a negotiable instrument) to a "qualified donee" (defined in subsection 248(1) with reference to the existing definition in subsection 149.1(1)) be made from an insurer, solely because of the insurer's obligations under the policy. The transfer can be provided for in the individual's will or in a non-testamentary written designation made by the individual.

A transfer is not eligible under this paragraph if the amount of the transfer

- is not included in computing the income of the individual or the individual's estate for any taxation year, but

- would have been included in computing the income of the individual or the individual's estate for a taxation year if the transfer had been made to the individual's legal representative for the benefit of the individual's estate and the Act were read without reference to subsection 70(3).

For example, a transfer to a qualified donee from a policy that is governed by a registered pension plan (RPP) would not satisfy the condition in paragraph 118.1(5.1)(*b*) because the amount of the transfer

- is not included in computing the income of the individual or the individual's estate (i.e., because paragraph 56(1)(*a*) provides that the amount of transfer is included in computing the income of the donee in its capacity as recipient), but

- would have been included in computing the income of the individual or the individual's estate under subsection 70(2) or paragraph 56(1)(*a*) if the transfer had been made to the individual's personal representative for the benefit of the individual's estate.

On the other hand,

- a transfer to a qualified donee from a policy that is or is governed by a registered retirement savings plan (RRSP) or a registered retirement income fund (RRIF) would, for example, be described in this exception (and so may satisfy the condition in paragraph 118.1(5.1)(*b*)) because the amount of the transfer to the donee is included in the income of the individual under the rules governing RRSPs and RRIFs; and

- a transfer to a qualified donee from a policy where the policy is independent of any plan or arrangement subject to the Act and the premiums for the policy were paid by an individual with after-tax income would generally not be described in this exception (and so may satisfy the condition in paragraph 118.1(5.1)(*b*)) because generally one of the following two circumstances exists:

    - the amount of the transfer to the donee is included in the income of the individual under section 148 of the Act, or

    - the amount of the transfer to the donee is not included in the income of the individual under section 148 and the amount of the transfer would not have been included in the income of the indidividual or the individual's estate under the Act if the transfer had been made to the individual's personal representative for the benefit of the individual's estate.

Paragraph 118.1(5.1)(*c*) requires that, immediately before the individual's death, the donee was neither a policyholder under the policy nor an assignee of the individual's interest under the policy. The conditions in paragraph 118.1(5.1)(*c*) are not satisfied, for example, where an individual takes out a life insurance policy and makes an absolute assignment of the policy to a qualified donee. It is generally understood that, in the latter case, the Canada Customs and Revenue Agency would take the position that the individual would be considered to have made a gift because of, and at the time of, the assignment. (See CCRA Interpretation Bulletin IT-244R3.)

Paragraph 118.1(5.1)(*c*) also requires that, immediately before the individual's death, the individual was a person whose consent was required to change the recipient of the transfer. Normally, this would mean that the individual must, immediately before death, have been the policyholder. However, in the context of group policies, the individual might instead have rights (immediately before death) in respect of the policy that could be enforced against the policyholder (e.g., the individual's employer or former employer).

Paragraph 118.1(5.1)(*d*) requires that the transfer occur not more than 36 months after the individual's death, or within such longer period as the Minister of National Revenue considers reasonable.

Where the conditions set out in paragraphs 118.1(5.1)(*a*) to (*d*) are satisfied in connection with a transfer under an insurance policy as a consequence of the death of an individual:

- the transfer is deemed to be a gift made by the individual immediately before the individual's death (paragraph 118.1(5.2)(*a*)); and

- the fair market value of that gift is deemed to be the fair market value, at the time of the individual's death, of the right to the transfer (paragraph 118.1(5.2))(*b*)). This fair market value is determined without reference to any risk of default with regard to the insurer's obligations. In nearly all cases, this is expected to be the fair market value, at the time of the individual's death, of the money (or of the proceeds of the negotiable instrument) ultimately transferred.

New subsections 118.1(5.1) and (5.2) apply to deaths that occur after 1998.

## Direct Designation – RRSPs and RRIFs

ITA
118.1(5.3)

New subsection 118.1(5.3) of the Act extends the charitable donations tax credit to a transfer of money (or a transfer by means of a negotiable instrument) from a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) (other than a plan or fund of which a "licensed annuities provider" is the issuer or carrier, as the case may be), where the transfer is made as a consequence of a qualified donee being named a beneficiary under the plan or fund. As a result, the charitable donations tax credit can be claimed on an individual's death as a consequence of transfers to qualified donees from such a plan or fund if the individual was the annuitant under the plan or fund. For this result to apply, the transfer must be made not more than 36 months after the individual's death, or within such longer period as the Minister of National Revenue considers reasonable.

Refer to the commentary on subsection 248(1) for a discussion of the definition "qualified donee".

In the case of gifts made from RRSPs and RRIFs where a "licensed annuities provider" (as defined in subsection 248(1)) is the issuer or carrier, new subsection 118.1(5.1) applies.

Where subsection 118.1(5.3) applies in connection with a transfer from an RRSP or RRIF under which an individual was the annuitant:

- the transfer of the property is deemed to be a gift made by the individual immediately before the individual's death (paragraph 118.1(5.3)(*a*)); and

- the fair market value of that gift is deemed to be the fair market value, at the time of the individual's death, of the right to the transfer, which fair market value is determined without reference to any risk of default with regard to the obligations of the issuer of the plan or the carrier of the fund (paragraph 118.1(5.3)(*b*)).

This amendment applies to deaths that occur after 1998.

## Gift of Capital Property

ITA
118.1(6)

Subsection 118.1(6) of the Act provides that, if an individual donates capital property to a charity, the individual may elect a value between the adjusted cost base and the fair market value of the donated property to be treated both as the proceeds of disposition for the purpose of calculating the individual's capital gain and the amount of the gift for the purpose of calculating the tax credit allowed for charitable donations under subsection 118.1(3) of the Act.

The amendment to subsection 118.1(6) of the Act is complementary to the amendment of subsection 118.1(12) of the Act, which provides that the fair market value of a gift of a covenant, easement or servitude in respect of ecologically sensitive land will not be considered to be less than the decrease in value of the subject land that resulted from the making of the gift. The amendments clarify that an individual donor may nevertheless report a reduced amount of proceeds of disposition of such a gift, where the value of the gift for the purpose of calculating the charitable donations tax credit is reduced accordingly. This amendment applies in respect of gifts made after February 27, 1995.

## Gifts of Artists' Inventory

ITA
118.1(7) and (7.1)

Subsection 118.1(7) of the Act provides that, if an artist donates artwork created by the artist and held in inventory, the artist may designate a value between the cost amount and the fair market value of the artwork to be treated both as the proceeds of disposition for the purpose of calculating the individual's income and the amount of the gift for the purpose of calculating the tax credit allowed for charitable donations under subsection 118.1(3). Such an amount may also be designated by the legal representative of a deceased artist, where the artwork is donated according to the late individual's will.

If the artwork is cultural property, as described in subsection 118.1(1) of the Act, subsection 118.1(7.1) of the Act applies instead of subsection (7) of the Act. Under subsection 118.1(7.1), the individual is also treated as having received proceeds of disposition equal to the cost amount to the individual of the work of art for the purpose of calculating the individual's income, but the fair market value of the artwork is not affected. This means that the artist is entitled to a credit based on the value of the donation, but that the deceased artist recognizes neither a profit nor a loss on the disposition of the work of art in computing income from the artist's business for income tax purposes.

Subsections (7) and (7.1) of the Act are amended to provide that, where artwork is donated as a result of the death of the individual, the gift is deemed to have been made by the individual immediately before the individual's death. These amendments clarify that the proceeds of disposition calculated under these subsections are relevant for the purpose of calculating the income of the late individual in the year of death.

Subsections 118.1(7) and (7.1) of the Act are also amended to apply to artwork that has been donated by an individual who acquired the artwork in circumstances where subsection 70(3) of the Act applied (i.e. as a "right or thing").

Upon the death of an individual, subsections 69(1.1) and 70(3) of the Act provide (if applicable) a rollover of "rights or things" of the late individual to beneficiaries or other persons beneficially interested in the estate or trust of the late individual. That is, if artwork of a late individual is a "right or thing," income from the ultimate disposition of the artwork will be attributed to the beneficiary. (Note, however, that subsection 70(3) of the Act does not apply where the late individual's legal representative has validly filed a "rights or things" return or where the time for filing such a return has expired before the transfer of the artwork to the beneficiary).

New subsections 118.1(7) and (7.1) of the Act apply to such an individual beneficiary if that beneficiary donates the artwork to the same effect as if the artwork had been donated by the deceased person.

These amendments generally apply to the 2000 and subsequent taxation years.

## Determination of Fair Market Value

ITA
118.1(10.1)

Subsection 118.1(10.1) of the Act applies, for the purposes of section 118.1 (donations and gifts by individuals) and section 110.1 of the Act (donations and gifts by corporations), where the Cultural Property Export Review Board has determined or redetermined the fair market value of a property. If the property is the subject of a gift that is made within two years after the Board's valuation, and is claimed as a charitable donation that is not a gift of cultural property, the Board's valuation is deemed to be determinative of the fair market value of the property for the purposes of sections 110.1 and 118.1. An amount equal to that value is also deemed to be the proceeds of disposition of the property, subject to elective provisions in subsections 110.1(3), 118.1(6) and (7).

Subsection 118.1(10.1) is amended to extend its application to determinations and redeterminations of value made by the Minister of the Environment under new subsections 118.1(10.3) and (10.4).

**Determination, Redetermination and Certification**

ITA
118.1(10.2) to (10.5)

New subsections 118.1(10.2) to (10.5) of the Act are added to provide administrative procedures regarding the request for a determination of fair market value from the Minister of the Environment, including notification, determination and redetermination. (Appeals to the Tax Court of Canada are provided for in new subsection 169(1.1) of the Act.) These amendments are concurrent with the amendment of paragraph 110.1(1)(*d*), "ecological gifts", and the definition "total ecological gifts" in subsection 118.1(1), which require that the fair market value of ecologically sensitive land (including a covenant, an easement or a servitude) be certified by the Minister of the Environment.

New subsection 118.1(10.2) of the Act provides that, where a person disposes of, or proposes to dispose of, a property that, with the appropriate certification by the Minister of the Environment, would qualify as an ecological gift, the person may request in writing that that Minister make a determination of the fair market value of the property. New subsection 118.1(10.3) provides that, where a person makes such a request before the end of the third taxation year of the person following the year in which the property was disposed of, the Minister of the Environment will notify the person of the determination made.

New subsection 118.1(10.4) of the Act provides for the opportunity to request, within 90 days of notification of the determination of fair market value of a property by the Minister of the Environment, a redetermination of that fair market value. That Minister may also take the initiative to redetermine the fair market value at any time, even where no request has been made. In either case, that Minister will issue a notice of redetermination, and the redetermined fair market value is deemed to replace any previous amount determined or redetermined.

It is not necessary for a gift to have been made in order for a determination or redetermination to be made in respect of a person's property, so long as the person has proposed to make a gift of the property. However, no tax credit will be available until the gift is made.

Where a person has made the gift, the fair market value of which has been determined or redetermined by the Minister of the Environment, to the federal government, a provincial or territorial government, a municipality or a registered charity approved by that Minister, the Minister of the Environment will issue a certificate that states the fair market value determined or redetermined by that Minister. Where more than one certificate has been issued (because of a redetermination of fair market value), the last such certificate is deemed to replace any preceding certificate.

These amendments apply to gifts made, or proposed to be made, after February 27, 2000.

**Assessments**

ITA
118.1(11)

Subsection 118.1(11) of the Act provides that an assessment of tax can be made at any time in order to give effect to a certificate issued by the Cultural Property Export Review Board or to a court decision which varies a determination of the Board. Subsection 165(1.2) of the Act provides that no objection may be made to an assessment made under subsection 118.1(11).

Subsection 118.1(11) is amended to extend its application, in respect of ecologically sensitive land, to an assessment of tax resulting from a certificate of fair market value issued by the Minister of the Environment or a decision of a court in respect of an appeal of a redetermination of that Minister under new subsection 169(1.1) of the Act. Subsection 165(1.2) continues to apply to deny the right to object to an assessment made under subsection 118.1(11). A person's right of review of a determination of fair market value by the Minister of the Environment is provided instead by new subsections 118.1(10.4) and 169(1.1).

This amendment applies to gifts made after February 27, 2000.

## Ecological Gifts

ITA
118.1(12)

Subsection 118.1(12) of the Act provides that the fair market value of a gift by an individual of a covenant, easement or servitude in respect of ecologically sensitive land will not be considered to be less than the decrease in value of the subject land that resulted from the making of the gift. Subsection 118.1(12) of the Act is amended to clarify that such amount will also be, subject to the designation of an amount under subsection 118.1(6), the donor's proceeds of disposition for the purposes of calculating income and capital gains. This amendment applies in respect of gifts made after February 27, 1995.

Subsection 118.1(12) is also amended concurrently with the definition of "total ecological gifts" in subsection 118.1(1), to provide that the fair market value of ecologically sensitive land (including a covenant, an easement or a servitude) and, consequentially, the individual's proceeds of disposition, is deemed to be the amount determined by the Minister of the Environment to be its fair market value.

This amendment applies to gifts made after February 27, 2000.

## Clause 95

## Medical Expense Tax Credit

ITA
118.2(2)(*l*.21)

Subsection 118.2(2) of the Act contains a list of expenditures which qualify as medical expenses for the purpose of the medical expense tax credit. New paragraph 118.2(2)(*l*.21) adds to this list reasonable expenses, relating to the construction of the principal place of residence of an individual who lacks normal physical development or has a severe and prolonged mobility impairment, that can reasonably be considered to be incremental costs incurred to enable the individual to gain access to, or to be mobile or functional within, the individual's principal place of residence. As for all medical expenses, the portion of the expenses which is reimbursed (through special financial assistance, sales tax rebate or otherwise) does not qualify for the medical expenses tax credit, except to the extent that the reimbursement is required to be included in income and is not otherwise deductible in computing taxable income.

This amendment applies to the 2000 and subsequent taxation years.

## Clause 96

### Disability Tax Credit

ITA
118.3

Section 118.3 of the Act provides a tax credit for individuals who have a severe and prolonged mental or physical impairment.

### Credit for Mental or Physical Impairment

ITA
118.3(1)

To be eligible for the disability tax credit (DTC) provided under section 118.3 of the Act, an individual must be markedly restricted in the activities of daily living. Even with the use of appropriate devices, medication or therapy, an individual must be either blind or generally unable to perform certain fundamental functions to qualify for the credit.

The preamble of the French version of subsection 118.3(1) of the Act is amended in light of the increase of the DTC (which is discussed below). Paragraphs 118.3(1)(*a*.1) and (*a*.2) are amended to extend eligibility for the DTC to individuals who would be so markedly restricted but for therapy administered to them at least three times each week for a total duration averaging not less than 14 hours a week in order to sustain one of their vital functions. Examples of taxpayers who will benefit from this extension include individuals with severe kidney disease requiring dialysis and persons with severe cystic fibrosis requiring clapping therapy in order to properly breathe.

These two amendments apply to the 2000 and subsequent taxation years.

Paragraph 118.3(1)(*a*.2) is further amended to authorize speech-language pathologists to certify a severe and prolonged speech impairment.

This amendment applies to certifications made after October 17, 2000.

Subsection 118.3(1) of the Act also provides the formula for calculating the DTC. Currently, under the formula, the amount of the credit is equal to 17% of $4,293. The amendment adds another component ("C") to the formula to provide, starting in 2000, a supplement amount of $2,941 for each disabled child under the age of 18 years at the end of the year. The supplement amount is reduced by the excess, over $2,000, of the total of child care and attendant care expenses paid in the year and claimed for income tax purposes in respect of the child. In 2001, the disability basic and supplement amounts are, after indexing, increased to $6,000 and $3,500, respectively. The $2,000 care expense threshold for 2001 is increased, through indexing, to $2,050.

## Disability Tax Credit Transfer

ITA
118.3(2)(*a*)(i)(B)

Subsection 118.3(2) of the Act provides criteria for determining the entitlement of a supporting individual of a disabled person to claim that person's unused disability tax credit. Currently, a supporting individual who is a parent, grandparent, child or grandchild of a disabled person may claim that person's unused disability tax credit (DTC) where a caregiver credit or an infirm dependant credit may be claimed by the individual in respect of the disabled person. The amendment extends the DTC transferability to other relatives of the disabled person who may claim the caregiver credit or the infirm dependant credit in respect of the disabled person. These include a supporting individual who is a brother, sister, aunt, uncle, nephew or niece of the disabled person, or of the spouse or common-law partner of the disabled person.

This amendment applies to the 2000 and subsequent taxation years.

### Additional Information

ITA
118.3(4)

Subsection 118.3(4) of the Act gives to the Department of Human Resources Development (DHRD) the authority to request, from the disabled person, the supporting individual who claims (in whole or in part) the DTC in respect of the disabled person, or the certifying health professional, additional information to determine the disabled person's entitlement to the DTC. In recent years, the Canada Customs and Revenue Agency has developed its own "in-house" medical staff and, as a result, the advice of DHRD is no longer sought with respect to DTC claims. Accordingly, subsection 118.3(4) is amended to delete references to DHRD. The subsection is also modified as a consequence of the amendment to paragraph 118.3(1)(*a*.1) which extends the eligibility to the DTC to certain individuals who must undergo extensive therapy subsection 118.3(1). For additional information about the amendment to that paragraph, see the commentary on subsection 118.3(1).

These amendments apply to the 2000 and subsequent taxation years.

## Clause 97

### Nature of Impairment – Reference to Medical Practitioner, etc.

ITA
118.4(2)

Subsection 118.4(2) of the Act provides a definition of the group of health professionals to whom various references in section 63 (relating to child care expenses), section 118.2 (relating to medical expenses), section 118.3 (relating to the disability tax credit) and section 118.6 (relating to the education tax credit) of the Act apply. This amendment is consequential to the amendment to paragraph 118.3 (1)(*a*.2) (see commentary on subsection 118.3(1)), which makes speech-language pathologists eligible to certify, after October 17, 2000, severe and prolonged speech impairments for the purpose of the disability tax credit.

This amendment applies to certifications made after October 17, 2000.

## Clause 98

## Education Tax Credit

ITA
118.6

Section 118.6 of the Act provides rules for determining the eligibility for the education tax credit.

ITA
118.6(1)

Subsection 118.6(1) of the Act provides the definition "designated educational institution" which is relevant for the purposes of the child care expense deduction and the tuition fee and education tax credits. Generally speaking, a designated educational institution is an institution providing post-secondary education, an educational institution certified by the Minister of Human Resources Development that furnishes or improves or improve skills in an occupation or a foreign university. The amendment to the preamble of that subsection is consequential to the amendment to section 64 (see commentary on that section), which broadens the scope of the deduction of attendant care expenses to include such expenses incurred to attend a designated educational institution.

This amendment applies to the 2000 and subsequent taxation years.

ITA
118.6(2)(*a*) and (*b*)

Subsection 118.6(2) of the Act provides the formula for the calculation of the education tax credit. For 2000, this tax credit is determined by multiplying the "appropriate percentage" (17 per cent) by $200 ($60 in the case of part-time students) by the number of months in the year during which an individual is enrolled in a qualifying program at a designated educational institution. This amendment doubles the monthly amounts for the 2001 and subsequent taxation years such that they will be set at $400 for full-time students and $120 for part-time students. Thus, for those years, the education tax credit will be computed by reference to those increased monthly amounts and the new lowest tax rate (16 per cent) applicable to individual.

This amendment applies to the 2001 and subsequent taxation years.

ITA
118.6(2)

Section 118.6 of the Act provides a tax credit computed by reference to the number of months in a calendar year in which a student is enrolled in a qualified educational program at a designated educational institution. The expressions "qualified educational program" and "designated educational institution" are defined in subsection 118.6(1). Essentially, the education tax credit is granted to students enrolled in post-secondary and vocational job-training courses which qualify for the purposes of the tuition fee tax credit. In the case of vocational schools, fees paid on behalf of students who are under 16 years of age do not qualify for the tuition fee tax credit. The amendment clarifies that a similar restriction applies for the purposes of the education tax credit.

This amendment applies to the 1999 and subsequent taxation years.

## Clause 99

## Unused Tuition and Education Tax Credit

ITA
118.61

Section 118.61 of the Act provides for the deduction of a student's carryforward of unused tuition and education tax credits, as calculated at the end of the previous year.

The amendments to the description of C in subsection 118.6(1) and to paragraph 118.61(2)(*b*) make the calculation of the student's unused tuition and education tax credits compatible with the ordering provided under section 118.92 for the claiming of non-refundable credits. As provided under that section, the tuition fee and education tax credits, as well as the carryforward of the unused portion of those credits, must be claimed before any part of those credits can be transferred to a spouse, common-law partner or supporting individual and before claiming any donation or dividend tax credit.

These amendments apply to the 1999 and subsequent taxation years.

New subsection 118.61(3) stipulates that the unused tuition and education tax credit at the end of 2000 is equal to 16/17 of what it would otherwise be. This adjustment is consequential to the reduction, from 17 to 16 per cent, of the rate at which personal credits are computed, ensuring that the carried-forward credit can offset tax on the same amount of income at the new 16% rate as it would have at the 17% rate.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 100

## CPP/QPP Contribution and EI Premium Tax Credit

ITA
118.7

Section 118.7 of the Act provides the formula for calculating an individual's tax credit in respect of CPP/QPP contributions and employment insurance premiums. The amendment to paragraph (*c*) of the description of B of that formula is consequential to the introduction of paragraph 60(*e*) (see commentary on that paragraph). New paragraph 60(*e*) provides for the deduction, in computing an individual's income, of one-half of the CPP/QPP contributions payable on the individual's self-employed earnings, subject to one-half of the maximum of such contributions payable by the individual under the plan. The amendment ensures that the tax credit granted to the individual under section 118.7 in respect of CPP/QPP contributions of the individual's self-employed earnings is computed by reference to the other half of such contributions.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 101

## Transfer of Tuition and Education Tax Credits

ITA
118.81

Section 118.81 of the Act provides for the calculation of the tuition and education tax credits that may be transferred under section 118.8 from a student to the student's spouse or common-law partner, or under section 118.9 to a parent or grandparent. The maximum annual amount that may be transferred is $850. This means that, given the current lowest rate of 17 per cent, a student may transfer up to the equivalent of $5,000 of unused tuition fee and education amounts. This amendment, which reduces from $850 to $800 the maximum annual amount transferable, is consequential to the reduction, from 17 to 16 per cent, of the lowest income tax rate applicable to individuals, maintaining the effect of the credit transfer in offsetting tax on up to $5,000 at the 16% rate.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 102

### Former Resident – Credit for Tax Paid

ITA
119

Existing section 119 of the Act provides for a five-year block averaging for farmers and fishermen. Since the section is no longer active, it is repealed effective for the 1995 and subsequent taxation years.

New section 119 of the Act, which is unrelated to repealed section 119, provides a special tax credit in certain cases where the "stop-loss" rule in new subsection 40(3.7) of the Act applies to an individual who ceased to be resident in Canada.

Under amended subsection 128.1(4) of the Act, individuals who emigrate from Canada are treated as having disposed of most properties, for proceeds equal to the fair market value of the properties. Such an individual may therefore be treated as having realized an accrued gain immediately before leaving Canada, and will be subject to tax on the gain. If the individual subsequently receives dividends in respect of the same property, a loss realized on a later disposition of the property may be reduced by new subsection 40(3.7) of the Act, and thus may not be available to offset the gain that resulted from the subsection 128.1(4) deemed disposition. Part or all of the tax liability arising from the gain would thus remain payable. However, the individual may also have paid tax on those post-departure dividends, under Part XIII of the Act.

New section 119 addresses this possible overlap between the tax resulting from the subsection 128.1(4) deemed disposition of a capital property and the Part XIII tax on dividends that reduce the taxpayer's loss on the property. In general terms, the rule allows a tax credit equal to the tax on those dividends, up to the amount of the tax on the capital gain that arose on emigration from Canada.

More specifically, section 119 allows the individual to deduct, in computing tax otherwise payable under Part I of the Act for the taxation year in which subsection 128.1(4) treated the individual as having disposed of the property, the lesser of two amounts. The first amount, described in paragraph 119(*a*), is in effect the amount of tax attributable to the gain on the property. This amount is computed as the proportion of the individual's Part I tax for that year that the taxable capital gain on the particular property is of the individual's total income for the year, as determined under new paragraph 114(*a*) of the Act.

The second amount, set out in paragraph 119(*b*), is the Part XIII withholding tax paid (or deemed to have been paid) by the individual on dividends that, under new subsection 40(3.7), have reduced the individual's loss from the disposition of the property. This amount is computed as the proportion of the individual's Part XIII tax in respect of dividends in respect of the property that the subsection 40(3.7) loss reduction is of the total amount of those dividends.

A consequential amendment to subsection 152(6) of the Act ensures that any necessary assessments of tax will be made in order to take account of the effect of new section 119.

New section 119 applies to dispositions after December 23, 1998 by individuals who cease to be resident after October 1, 1996.

## Clause 103

## Income Not Earned in a Province

ITA
120

Section 120 of the Act sets out rules that integrate the federal and provincial income tax systems for individuals. Subsection 120(1) imposes an additional amount of federal tax on income that is not subject to provincial or territorial tax, while subsection 120(2) provides part of the tax abatement for income earned in Quebec (the rest is found in legislation concerning federal-provincial fiscal arrangements).

ITA
120(1)

Subsection 120(1) of the Act provides for the payment by an individual of an additional tax of 52% of the federal tax otherwise payable in respect of the portion of the individual's income for the year that is not earned in a province. The additional tax has the effect of setting the individual's tax on income earned outside Canada at a level approximating that which would apply if provincial income tax were exigible (i.e., combined federal plus provincial tax).

The subsection is amended to reduce the rate of the additional tax to 48%, from 52%, for the 2000 and subsequent taxation years, in recognition of reductions to tax rates in the provinces.

ITA
120(2.1)

Subsection 120(2.1) of the Act provides a special rule for computing the amount that is considered, under subsection 120(2), to have been paid on behalf of an individual's tax for a taxation year. This special rule applies where existing section 119 of the Act applies to the individual for the year. Existing section 119 is no longer active, and is replaced with a new, unrelated rule. Subsection 120(2.1) is therefore repealed for the 1996 and subsequent years.

ITA
120(3)

For the purposes of subsections 120(1) and (2) of the Act, subsection 120(3) defines the phrase "the individual's income for the year" where sections 114 or 115 of the Act – dealing with part-year residents and non-residents, respectively – apply in respect of the individual for the year. Subsection 120(3) is amended, with application to the 1998 and subsequent taxation years, as a consequence of changes to section 114 of the Act. The amendment makes no substantive change, but keeps the reference in step with the changes to section 114. For additional information, see the commentary on section 114.

ITA
120(4)

Subsection 120(4) includes a definition of "tax otherwise payable under this Part". The amendment to this subsection, which applies to the 1996 and subsequent taxation years, excludes from the definition any deduction from tax in respect of the new credit, under section 119 of the Act, for certain taxes paid by a former resident of Canada. In order to take into account an amendment to the definition of "tax otherwise payable under this Part" in the 1999 budget bill [(S.C. 2000, c,19 (formerly Bill C-25)], a special transitional rule is provided for taxation years that end before 2000.

## Clause 104

### Minimum Tax

ITA
120.2(4)

Section 120.2 of the Act allows an individual to apply additional taxes, imposed for a given year under the section 127.5 minimum tax, against the individual's ordinary Part I tax liabilities for following years. Paragraph 120.2(4)(*b*) prevents such a carryforward in respect of any taxation year in which the taxpayer has elected under existing section 119 of the Act. Existing section 119 no longer applies, and is replaced with an unrelated new rule. Subsection 120.2(4) is therefore restructured to remove its reference to section 119. This amendment applies to the 1996 and subsequent taxation years.

## Clause 105

### Tax Payable by *Inter Vivos* Trust

ITA
122(2)

Subsection 122(1) provides that *inter vivos* trusts are generally subject to income tax at top marginal income tax rates. Subsection 122(2) of the Act permits certain pre-1972 *inter vivos* trusts access to graduated income tax rates.

Subsection 122(2) is amended to ensure that this special treatment does not apply to a trust in the event that property has been transferred after December 17, 1999 to the trust from another trust to which subsection 122(1) applies, if there was no change in the beneficial ownership of the property on its transfer.

This amendment applies to the 1999 and subsequent taxation years.

## Clause 106

## Deduction from Tax Payable where Employment out of Canada

ITA
122.3(1)(*e*)

Section 122.3 of the Act provides a tax credit to Canadian residents who are employed outside Canada by a specified employer for at least six months in connection with resource, construction, installation, agricultural or engineering contracts or for the purpose of obtaining those contracts. This credit – commonly known as the Overseas Employment Tax Credit (OETC) – effectively eliminates 80% of the Canadian tax arising on the first $100,000 of salary or wages earned from such foreign employment.

The OETC is determined by multiplying an employee's Part I tax otherwise payable for a taxation year by a fraction: the numerator of that fraction, determined under paragraphs 122.3(*c*) and (*d*) of the Act, generally consists of the lesser of $80,000 and 80% of the individual's overseas employment income for the year; the denominator, determined under paragraph 122.3(1)(*e*), is the individual's income for the year (or, where section 114 of the Act applies, for the period or periods in the year throughout which the individual is resident in Canada) reduced by certain deductions listed in subparagraph 122.3(1)(*e*)(iii).

Paragraph 122.3(1)(*e*) is amended, with application to the 1998 and subsequent taxation years, as a consequence of changes to section 114 of the Act. The amendment makes no substantive change, but keeps the reference in step with the changes to section 114. For additional information, see the commentary on section 114.

## Clause 107

## Goods and Services Tax Credit (GSTC)

ITA
122.5(5.1)

Section 122.5 of the Act provides for the payment to an eligible individual of a refundable GSTC, computed by reference to the individual's income and family status at the end of the previous year. This credit is payable in advance in four "months specified" for that purpose: July, October, January and April. Given the prospective nature of the quarterly GSTC payments, paragraph 122.5(5)(*c*) provides that an individual's entitlement to the GSTC ceases upon the death of the individual or once the individual has become non-resident. This amendment, through the addition of section 122.5(5.1), provides a similar rule with respect to an individual who is confined to a prison or similar institution. Thus, an individual who is so confined during the 12-month period that ends on June 30, 2002 will be denied the GSTC for all months specified for the 2000 taxation year (i.e., July and October 2001 and January and April 2002), unless the individual satisfies the Minister of National Revenue that the confinement was for a period of not more than 6 months included in that 12-month period.

This amendment applies to amounts deemed to be paid during months specified for the 2000 taxation year.

As indicated in the 1999 Budget Plan, the government intends to make the GSTC more responsive to changing circumstances of GSTC recipients. As it is expected that this, more general, reform will be in place for the July 2002 GSTC payments, this amendment is proposed to apply only until that month. As of July 2002, it is intended that a revised measure consistent with the general changes to GSTC will apply.

## Clause 108

### Refundable Medical Expense Supplement

ITA
122.51(2)

Section 122.51 of the Act provides a refundable medical expense supplement. The supplement is equal to the lesser of $500 and 25/17 of the medical expense tax credit claimed by an eligible individual for the year. The supplement is reduced by 5% of the individual's "adjusted income" in excess of an indexed threshold ($17,664 for 2000).

Paragraph (*b*) of the description of A in subsection 122.51(2) is amended to replace the reference to "25/17" with a reference to "25/16", consequential to the reduction, from 17% to 16%, of the lowest tax rate applicable to individuals.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 109

### Canada Child Tax Benefit – Definition "Eligible Individual"

ITA
122.6

Section 122.6 of the Act defines a number of terms which apply for the Canada Child Tax Benefit (CCTB) purposes. Paragraph (*e*) of the definition "eligible individual" includes certain requirements that must be met in order for an individual to be eligible for the CCTB. That paragraph provides that an individual who has been determined under the *Immigration Act* (or its regulations) to be a Convention refugee becomes (provided all other conditions are met) an eligible individual in the month following that of the determination. New subparagraph (*e*)(iv) of the definition "eligible individual" provides for a similar recognition of individuals who, for Canadian immigration purposes, are treated like Convention refugees. Those individuals are members of classes defined in the *Humanitarian Designated Regulations* made for the purposes of the *Immigration Act*.

This amendment applies with respect to CCTB paid for months that are after June 2001.

## Clause 110

## Canada Child Tax Benefit

ITA
122.61 and 122.63

Subsection 122.61(1) of the Act contains the calculation of the Canada Child Tax Benefit (CCTB). The CCTB is made up of two parts: a basic amount and a National Child Benefit (NCB) supplement. Unlike the basic amount, the amount of the NCB supplement payable to a family in respect of each qualified dependant varies depending on the number of qualified dependants in the family. Currently, the NCB supplement is $1,155 for the first qualified dependant, $955 for the second qualified dependant and $880 for each of the third and subsequent qualified dependants. Subsection 122.61(1) is amended to increase each of those three amounts by $100.

Currently, the CCTB is reduced by 5 per cent of family net income in excess of the lower income threshold for the second income tax bracket ($30,754 for 2001). These amendments increase this threshold to the greater of $32,000 and the indexed $30,754 income threshold.

These two amendments apply with respect to CCTB paid for months that are after June 2001.

Section 122.63 of the Act permits the Minister of Finance to enter into an agreement with a province to modify the CCTB basic amount with respect to residents of that province. Subsection 122.61(6.1) provides that, for CCTB paid for months that are after June 2001 and before July 2002, the indexing factor for that 12-month period is equal 1090/1104 of the indexing factor that would otherwise be used, provided that latter factor exceeds 1.4 per cent. Since the indexing factor to be used for that period is 2.5 per cent, the "modified" CCTB basic amount for that period should be determined in accordance with the following formula:

[A x (1.025 x 1090/1104)] or [A x 1.012]

where A is the modified CCTB ammount for the preceding 12-month period.

Because subsection 122.61(6.1) refers to the amount determined under subparagraph 122.61(5)(*b*)(ii) [i.e., 0.012] and not the amount determined under subsection 122.61(5) [i.e., 1.012], the amendment to subsection 122.61(6.1) ensures that, for the purpose of any agreement to which subsection 122.63 applies, the amount determined under subparagraph 122.61(5)(*b*)(ii) is equal to 0.012.

This amendment applies with respect to CCTB paid for months that are after June 2001 and before July 2002.

As indicated above, the phase-out rate of the CCTB is currently set at 5 per cent (2 1/2 per cent for families with only one qualified dependant). These amendments reduce this rate to 4 per cent (2 per cent for families with only one qualified dependant) with respect to CCTB paid for months that are after June 2004.

## Clause 111

### Corporate Surtax

ITA
123.2

Section 123.2 of the Act levies a 4% surtax on the tax payable under Part I of the Act by a corporation, other than a non-resident-owned investment corporation.

The surtax is calculated by reference to federal corporate tax payable after the 10-per-cent provincial abatement, but before tax credits such as the small business deduction and the manufacturing and processing deduction.

Paragraph 123.2(*a*) is amended to provide that the corporate surtax is to be based on the amount of federal income tax payable before taking into account any deduction under new section 123.4 as well. New section 123.4 of the Act provides a tax reduction to all corporations and an additional tax reduction to Canadian controlled private corporations.

The amendment applies to the 2001 and subsequent taxation years.

## Clause 112

### Corporation Tax Reductions

ITA
123.4

New section 123.4 of the Act contains rules that allow a corporation to reduce its tax otherwise payable under Part I of the Act by a percentage of the corporation's "full rate taxable income" – a term that is separately defined in the section for Canadian-controlled private corporations (CCPCs) and for other corporations. The applicable percentage will increase in stages from 1% for 2001 to 7% after 2003. Investment corporations, mortgage investment corporations, mutual fund corporations and non-resident owned investment corporations are not eligible for this rate reduction.

New section 123.4 also contains an additional rate reduction specific to CCPC's. This additional rate reduction is, in broad terms, equal to 7% of up to $100,000 of the CCPC's active business income in excess of the amount that benefits from the special rate for small-business income provided under section 125 of the Act.

Both the corporate rate reduction and the additional CCPC reduction apply to the 2001 and subsequent taxation years, and are prorated to reflect the number of days in a corporation's taxation year that fall in a given calendar year.

### Definitions

ITA
123.4(1)

New subsection 123.4(1) of the Act sets out three definitions for the purposes of new section 123.4.

"CCPC rate reduction percentage"

A Canadian-controlled private corporation's "CCPC rate reduction percentage" for a taxation year is that proportion of 7% that the number of days in the corporation's taxation year that are after 2000 is of the total number of days in the year.

"full rate taxable income"

The "full rate taxable income" of a corporation for a taxation year is, in general terms, that part of the corporation's taxable income for the year that has not benefited from any of the various special effective tax rates provided under the Act. This amount is determined differently depending on the nature of the corporation. Paragraph (*a*) of the definition applies to corporations other than CCPCs and various "specialty corporations" such as investment corporations and mutual fund corporations. Paragraph (*b*) applies to CCPCs. Investment corporations, mortgage investment corporations, mutual fund corporations and non-resident-owned investment corporations are dealt with in paragraph (*c*); their full rate taxable income is nil.

Under paragraph (*a*), the full rate taxable income of a corporation is the amount by which the corporation's taxable income for the year exceeds the total of the following four amounts:

(i) 100/7 of any amount deducted by the corporation from its tax for the year as a manufacturing and processing profits deduction under subsection 125.1(1) of the Act;

(ii) if the corporation deducted from its tax, under subsection 125.1(2) of the Act, an amount relating to the creation of electrical energy for sale or steam used to create electrical energy, the amount determined by the formula in that subsection;

(iii) three times the total of all amounts claimed by the corporation under paragraph 20(1)(*v*.1) of the Act as resource allowances for the taxation year; and

(iv) if the corporation is a credit union and claimed the special deduction for credit unions under subsection 137(3) of the Act, 100/16 of amount claimed.

A corporation that is a CCPC throughout a taxation year must use paragraph (*b*) to calculate its full rate taxable income for the year. The full rate taxable income of such a CCPC is the amount by which the CCPC's taxable income for the year exceeds the total of the following items:

(i) The amounts that would be determined under subparagraphs (*a*)(i) to (iv) if paragraph (*a*) applied to the corporation;

(ii) 100/16 of the amount of the small business deduction claimed by the corporation for the year, under subsection 125(1) of the Act;

(iii) The corporation's aggregate investment income for the year, as defined in subsection 129(1) of the Act; and

(iv) 100/7 of any amount deducted under subsection 123.4(3) from the corporation's tax for the year (CCPC rate reduction – see below).

Paragraph (*c*) applies to corporations that throughout the year are investment corporations, mortgage investment corporations, mutual fund corporations or non-resident owned investment corporations. As noted above, these corporations have no full rate taxable income, and thus are not eligible for the rate reductions.

"general rate reduction percentage"

A corporation's "general rate reduction percentage" for a taxation year is a percentage that is computed by reference to the calendar year or years in which the taxation year falls. The percentage is the total of 1% for any portion of the taxation year that falls in 2001, 3% for any portion in 2002, 5% for 2003, and 7% for 2004 and later calendar years.

For example, if a corporation's taxation year begins on July 1, 2002 and ends on June 30, 2003, the corporation's general rate reduction percentage for the taxation year is approximately 3.99%, computed as follows:

$$\begin{array}{rlr} & 184/365 \times 3\% = & 1.51\% \\ + & 181/365 \times 5\% = & \underline{2.48\%} \\ & & 3.99\% \end{array}$$

## General Deduction from Tax

ITA
123.4(2)

New subsection 123.4(2) of the Act allows a corporation a deduction from its tax otherwise payable under Part I of the Act for a taxation year. The amount of the deduction is determined by multiplying the corporation's general rate reduction percentage for the year by the corporation's full-rate taxable income for the year.

## CCPC deduction

ITA
123.4(3)

New subsection 123.4(3) of the Act allows a Canadian-controlled private corporation to deduct an amount from its tax otherwise payable for a taxation year under Part I of the Act. In general terms, as a result of this deduction the corporate tax rate on income between $200,000 and $300,000 earned by a CCPC from an active business carried on in Canada will be reduced to 21 per cent from 28 per cent, effective January 1, 2001. Associated corporations must share this deduction in proportion to their small business limit. Income eligible for this deduction is reduced to the extent that the corporation has income that has already benefited from a reduced effective tax rate. More particularly, the deduction is computed in a three-step process.

First, the corporation determines the least of the following three amounts:

(i) 3/2 of the corporation's business limit for the year as determined under section 125 of the Act for the purpose of paragraph 125(1)(*c*). This reference to all of section 125 ensures that the section's various modifications of the corporation's business limit apply for this purpose.

(ii) The amount that would have been the corporation's net active business income for the year, under paragraph 125(1)(*a*) of the Act, if the amounts contained in the description of M in the definition "specified partnership income" in subsection 125(7) of the Act were read as $300,000 and $822, instead of $200,000 and $548, respectively. This adjustment – multiplying those amounts by 3/2 – ensures appropriate results in cases where the corporation has specified partnership income for the year.

(iii) The amount by which the amount that would be determined under paragraph 125(1)(*b*) in respect of the corporation for the year, if the foreign tax credit in subsection 126(1) did not apply in respect of the corporation's aggregate investment income (AII) for the year, exceeds that AII. For this purpose, the determination of AII under subsection 129(4) is used.

Second, the corporation subtracts from the least of the above amounts the total of the following:

(i) The total of the amounts that would have been determined under subparagraphs (*a*)(i) to (iv) of the definition "full-rate taxable income" had paragraph (*a*) of that definition applied to the corporation; and

(ii) 100/16 times the amount of the small business deduction claimed by the corporation under subsection 125(1) of the Act.

Third, any remainder is multiplied by the corporation's CCPC rate reduction percentage for the year. The product is the amount of the deduction for the year.

## Clause 113

### Small Business Deduction

ITA
125

Section 125 of the Act provides for a corporate tax reduction (called the "small business deduction") in respect of income of a

Canadian-controlled private corporation (CCPC) from an active business carried on by it in Canada.

ITA
125(1)

Subsection 125(1) of the Act provides the basic rules for the calculation of a CCPC's small business deduction. The small business deduction is provided by way of an annual tax credit which is calculated as 16% of the least of certain amounts. One of the amounts, in paragraph 125(1)(*b*), is the amount by which the corporation's taxable income for the taxation year exceeds that portion of its income that supported a foreign tax credit (FTC) – which portion is determined by grossing-up the corporation's FTCs for the year. To prevent a possible circularity in the calculation of the small business deduction, this paragraph is amended to exclude, in determining for this purpose the amount of the corporation's FTCs, the effect of the deductions from tax provided under new section 123.4 of the Act.

Amended paragraph 125(1)(*b*) applies to the 2001 and subsequent taxation years.

ITA
125(7)

"Canadian-controlled private corporation"

Subsection 125(7) of the Act defines "Canadian-controlled private corporation", among other terms. This definition applies not only to the small business deduction under section 125 of the Act but also, through its incorporation by reference into subsection 248(1) of the Act, to the Act as a whole.

Currently, a corporation is a CCPC if it is a private corporation and a Canadian corporation (both of which terms are defined in subsection 89(1) of the Act), and it is not controlled, directly or indirectly in any manner whatever by one or any combination of public corporations (other than prescribed venture capital corporations) or non-resident persons. A corporation controlled by a group of non-residents or public corporations is not considered a CCPC if each share held by non-residents or public corporations, when attributed to a notional person, results in the notional person having control of the underlying corporation. Nor is a corporation a CCPC if it lists its stock on a prescribed stock exchange in Canada (Regulation 3200) or outside of Canada (Regulation 3201).

This amendment ensures that a corporation controlled by a Canadian resident corporation that lists its shares on a prescribed stock exchange outside of Canada is not a CCPC. This mirrors the treatment of corporations controlled by a Canadian resident corporation that lists its shares on a prescribed stock exchange in Canada (public corporation). Under the current definition these corporations are not CCPCs.

This amendment applies to taxation years beginning after 1999.

## Clause 114

## Manufacturing and Processing Profits Deduction

ITA
125.1

Section 125.1 of the Act provides a reduced rate of corporate tax on Canadian manufacturing and processing profits. Generally, the rate reduction takes the form of the deduction, from Part I tax otherwise payable, of an amount equal to a specified percentage – currently 7% – of a corporation's "Canadian manufacturing and processing profits" (other than profits eligible for the small business deduction under section 125 of the Act).

ITA
125.1(1)

Subsection 125.1(1) of the Act provides the basic rules for the calculation of a corporation's manufacturing and processing profits deduction. The deduction for a given taxation year is the lesser of two amounts, one of which is the corporation's taxable income less certain other amounts. One of these other amounts, described in paragraph 125.1(1)(*b*), is the grossed-up amount of the corporation's foreign tax credits (FTCs) for the year in respect of foreign business. To prevent a possible circularity in the calculation of the deduction, paragraph 125.1(1)(*b*) is amended to exclude, in determining for this purpose the amount of the corporation's FTCs, the effect of the deductions from tax provided under new section 123.4 of the Act.

Amended paragraph 125.1(1)(*b*) applies to the 2001 and subsequent taxation years.

ITA
125.1(2) and (5)

The definition "Canadian manufacturing and processing profits" in subsection 125.1(3) of the Act provides, among other things, that such profits are to be determined under rules prescribed by regulation to be applicable to the "manufacturing or processing in Canada of goods for sale or lease". The definition "manufacturing or processing" in subsection 125.1(3) precludes certain activities from being "manufacturing or processing" activities to which the 7% corporate tax rate reduction in subsection 125.1(1) applies. The list of excluded activities includes producing or processing electrical energy or steam, for sale.

However, subsection 125.1(2) extends the 7% corporate tax rate reduction to a corporation that generates electrical energy for sale, or produces steam for use in the generation of electrical energy for sale. Subsection 125.1(2) is amended to also apply to the production of "steam for sale", regardless of the end use of the steam.

Subsection 125.1(5) provides rules of interpretation for the purpose of applying subsection 125.1(2) and related Regulations (other than section 5201 of the *Income Tax Regulations*). Paragraph 125.1(5)(*a*) provides that electrical energy is deemed to be a good for the purpose of computing the value of the description of A in subsection 125.1(2). Also, paragraph 125.1(5)(*b*) deems the generation of electrical energy for sale, or the production steam for use in the generation of electrical energy for sale, to be manufacturing or processing, subject to the 10% gross revenue rule in paragraph (*l*) of the definition "manufacturing or processing". Unless the 10% gross revenue rule is met by a corporation, the corporation's activity is deemed to be excluded from the meaning of "manufacturing or processing".

For the purposes for which subsection 125.1(5) applies, paragraph 125.1(5)(*a*) is amended to deem steam to be a good and paragraph

125.1(5)(*b*) is amended to deem the production of "steam for sale" to be manufacturing or processing (other than for the purpose of applying the 10% gross revenue test in paragraph (*l*) of the definition "manufacturing or processing" in subsection 125.1(3)).

The tax rate reduction available under these changes is phased in beginning January 1, 2000, with a three percentage point tax rate reduction for the calendar year 2000. The phase in to a full seven-percentage point tax rate reduction will be completed in 2002. The coming-into-force provision provides for a pro-ration of the tax rate reductions for taxation years that straddle calendar years. A taxation year could begin in 2001 and end in 2003 because of the 53-week taxation year rule, and because of this paragraphs (*f*) and (*g*) of the coming-into-force rule both refer to the 7% rate applicable to the calendar years 2002 and 2003, respectively.

## Clause 115

## Canadian Film or Video Production Tax Credit

ITA
125.4(2)

Section 125.4 of the Act generally provides for a tax credit in respect of qualified labour expenditures incurred after 1994 by a qualified corporation for the production of a Canadian film or video production certified by the Minister of Canadian Heritage.

Paragraph 125.4(2)(*a*) of the Act is amended to clarify that qualified labour expenditures do not include an amount claimed as an expenditure in respect of Scientific Research and Experimental Development under section 37 of the Act.

This amendment applies after November 1999.

## Clause 116

### Film or Video Production Services Tax Credit

ITA
125.5(1)

"eligible production corporation"

The film or video production services tax credit is generally available in respect of qualifying Canadian labour expenditures of an "eligible production corporation" (as defined in subsection 125.5(1) of the Act) that carries on a business in Canada that is primarily a film or video production business or a production services business. An eligible production corporation does not include a corporation which is a tax-exempt entity, a corporation controlled by one or more tax-exempt entities or a prescribed labour-sponsored venture capital corporation.

The definition of "eligible production corporation" is amended to clarify that such corporations will not qualify as eligible production corporations if they are at any time in their taxation year such a corporation.

This amendment applies after November 1999.

## Clause 117

### Foreign Tax Credit

ITA
126

Section 126 of the Act provides rules under which taxpayers may deduct, from tax otherwise payable, amounts they have paid in respect of foreign taxes.

ITA
126(1)(*b*)(ii)(A)

Subsection 126(1) of the Act provides a tax credit in respect of foreign non-business income tax – that is, foreign taxes levied on investment and other non-business income. The credit is determined by multiplying the taxpayer's Part I tax otherwise payable for a taxation year by a fraction: the numerator of that fraction, determined under 126(1)(*b*)(i), consists of the taxpayer's income for the year (or, where section 114 applies, for the period or periods in the year throughout which the taxpayer is resident in Canada) from sources in the particular country calculated on certain assumptions; the denominator of that fraction, determined under paragraph 126(1)(*b*)(ii), consists generally of the amount by which the taxpayer's income for the year (or, where section 114 applies, for the period or periods in the year throughout which the taxpayer is resident in Canada) exceeds the deductions listed in subclause 126(1)(*b*)(ii)(A)(III).

Clause 126(1)(*b*)(ii)(A) is amended, with application to the 1998 and subsequent taxation years, as a consequence of changes to section 114 of the Act. The amendment removes a reference in subclause 126(1)(*b*)(ii)(A)(I) to section 114, updates the reference to that section in the following subclause, and simplifies the reference in subclause 126(1)(*b*)(ii)(A)(III) to the taxpayer's taxable income for the year. These changes keep the provision in step with the changes to section 114. For additional information, see the commentary on section 114.

## Authorized Foreign Banks

ITA
126(1.1)

Foreign tax credits are generally available only to persons resident in Canada. New subsection 126(1.1) of the Act gives an authorized foreign bank access to credits for foreign non-business-income tax paid in respect of its Canadian banking business. This provision is essentially a series of directions to read the existing foreign tax credit rules (and certain related provisions) in special ways. These directions are as follows:

- An authorized foreign bank is deemed to be resident in Canada, in respect of its Canadian banking business, for the purposes of the foreign non-business-income tax credit in subsection 126(1) of the Act, the limitations on that credit in subsections 126(4) to (5), the interpretive and related rules in subsection 126(6), and the definitions in subsection 126(7).

- The references in subsection 20(12) of the Act (deduction for foreign tax) and paragraph 126(1)(*a*) to a country other than Canada are to be read as references to a country that is neither Canada nor a country in which the authorized foreign bank is resident at any time in the year. This ensures, in keeping with standard international practice, that Canada – and not the bank's home country – retains the first right to tax the bank's Canadian business income (subject to credit for third-country taxes).

- The limit on the foreign non-business-income tax credit, in paragraph 126(1)(*b*), is computed by reference to the lesser of the authorized foreign bank's taxable income earned in Canada and its income for the year from its Canadian banking business (together with any addition under new subparagraph 115(1)(*a*)(vii)), rather than by reference to its income. Without this special reading, the bank's foreign tax credits would be inappropriately constrained if, for example, the bank had a large amount of income outside its Canadian business.

- The non-business-income tax paid by an authorized foreign bank to the government of another country is restricted to taxes that relate to amounts included in computing the bank's taxable income earned in Canada from its Canadian banking business.

- The definition "tax-exempt income" in subsection 126(7) is modified to describe tax agreements or conventions between an authorized foreign bank's home country and another country rather than using the defined term "tax treaty," which encompasses only a treaty between Canada and another country.

New subsection 126(1.1) applies after June 27, 1999.

## Amount Determined for Purposes of Paragraph (2)(*b*)

ITA
126(2.1)(*a*)(ii)(A)

Subsection 126(2.1) of the Act sets out a limit for the amount of a taxpayer's deduction under subsection 126(2) in respect of businesses carried on by the taxpayer in a country other than Canada.

The limit is the total of amounts computed under paragraphs 126(2.1)(*a*) and (*b*). The paragraph (*a*) amount is computed by multiplying the taxpayer's Part I tax otherwise payable for a taxation year by a fraction. The numerator of that fraction, determined under subparagraph 126(2.1)(*a*)(i), generally consists of a taxpayer's income for the year (or, where section 114 applies, for the period or periods in the year throughout which the taxpayer is resident in Canada) from businesses carried on by the taxpayer in the particular country. The denominator of this fraction, determined under subparagraph 126(2.1)(*a*)(ii), consists generally of the amount by which the taxpayer's income for the year (or, where section 114 applies, for the period or periods in the year throughout which the taxpayer is resident in Canada) exceeds the deductions listed in subclause 126(2.1)(*a*)(i)(A)(III).

Clause 126(2.1)(*a*)(ii)(A) is amended, with application to the 1998 and subsequent taxation years, as a consequence of changes to section 114. The changes update the references in the clause to section 114. For additional information, see the commentary on section 114.

## Non-resident's Foreign Tax Deduction

ITA
126(2.2)

Canada generally makes foreign tax credits available only to persons who are resident in Canada. The only current exception to this principle is subsection 126(2.2), which provides a foreign tax credit to a non-resident individual who, as an emigrant from Canada, made the election provided under existing subparagraph 128.1(4)(*b*)(iv) of the Act in respect of one or more properties that were not taxable Canadian property.

With this election and the provision of security, the individual emigrant could choose to treat the properties as taxable Canadian property. That meant, on the one hand, that the individual was not treated as having disposed of those properties on emigration; but on the other hand, that any post-departure gain on the properties remained subject to Canadian tax (assuming no tax treaty applied). On the ultimate disposition of the deemed taxable Canadian property, subsection 126(2.2) allowed the former Canadian resident a credit for foreign tax on the gain.

Under the new rules for emigrants from Canada, the election in subparagraph 128.1(4)(*b*)(iv) is no longer available. Subsection 126(2.2) is therefore amended to apply only to properties that were deemed to be taxable Canadian properties under the election as it read before October 2, 1996. This amendment applies to the 1996 and subsequent taxation years.

Subsection 126(2.2) is also amended, with application to the 1998 and subsequent taxation years, to reflect the changes to section 114 of the Act. For additional information, see the commentary on section 114.

## Former Resident

ITA
126(2.21) and (2.22)

In some circumstances, an individual who is a former resident of Canada may be subject to tax in another country on a gain that accrued while the individual was resident in Canada, and that has already been subject to Canadian tax on emigration. Similarly, the non-resident beneficiary of a Canadian trust who receives trust property on a distribution may be taxed abroad on a gain that accrued while the property was held by the trust, and that has been taxed in Canada on the distribution.

> ***Example** – double taxation of pre-departure gain*
>
> *Lee emigrates from Canada to Treatyland at a time when he owns a house in Treatyland. Lee bought the house while resident in Canada; at the time of emigration, the house has an adjusted cost base of $60,000 and a fair market value of $100,000. The*

*resulting $40,000 latent capital gain will produce a taxable capital gain of $30,000 immediately before departure, and that taxable capital gain will be subject to Canadian tax.*

*Assume that the house increases in value to $120,000 after Lee leaves Canada, and that Lee sells the property in 2005 for that amount.*

*In principle, the gain that has been subject to Canadian tax ought not to be taxed a second time. However, Treatyland may not yet recognize the tax effect of changes in residence and may simply tax Lee, when the property is disposed of, on the full amount of the his gain since first acquiring the property. In that case, Treatyland will tax not only the $20,000 gain realized since Lee left Canada, but also the $40,000 gain that accrued while Lee was resident in Canada. In the end, Lee is taxed twice on the same gain.*

The best way to alleviate such results is to modify Canada's tax treaties to ensure appropriate recognition for the Canadian tax that arises on departure. However, treaty changes can take considerable time. As an interim measure, new subsection 126(2.21) provides limited credits against an individual's Canadian tax that arises in the year of the individual's departure from Canada, for post-departure foreign taxes. These foreign taxes can comprise both business-income and non-business-income taxes (defined in subsection 126(7)). New subsection 126(2.22) provides similar limited credits against a trust's Canadian tax that arose in the year of a distribution by the trust to a non-resident beneficiary, for the beneficiary's subsequent foreign taxes. It is intended that these interim foreign tax credits will be reviewed by the Government of Canada as appropriate treaty changes are put in place.

Subsections 126(2.21) and (2.22) will apply, in most cases, only for taxes paid to countries with which Canada has a tax treaty. Exceptions are provided for taxes imposed by a foreign country on gains on real property situated in that country. In keeping with the general international principle that the country in which real property is located has the first right to tax gains on that real property, Canada will always provide credit for such taxes. Similarly, credit for those taxes will be available regardless whether Canada has a tax treaty with the particular country.

More specifically, subject to the conditions described above, the credit provided to an individual under new subsection 126(2.21) is computed on a property-by-property basis, as the lesser of two amounts.

The first amount, described in paragraph 126(2.21)(*a*), is the total of those portions of the foreign taxes paid in respect of the disposition of the property that can reasonably be considered to relate to the portion of the gain or profit in question that arose before the individual's emigration from Canada. Where the property in question is real property situated outside Canada, the creditable taxes are those paid to the government of the country where the property is located or, to the government of another country in which the individual is resident and with which Canada has a tax treaty.

The second amount, described in paragraph 126(2.21)(*b*), is in effect the amount of the individual's tax under Part I of the Act for the year of emigration that is attributable to the deemed disposition of the particular property under paragraph 128.1(4)(*b*) of the Act. In determining this amount, previous applications of subsection 126(2.21) are taken into account.

> ***Example*** *– operation of new credit*
>
> *In the example above, Lee will be able to claim a credit for the lesser of 2/3 ($40,000/$60,000) of the Treatyland tax on the total amount of the gain, and the Canadian tax that arose because of the deemed disposition on emigration. The credit will be applied against Lee's Canadian tax for the emigration year, with amended subsection 152(6) allowing any necessary reassessment.*
>
> *Note that since the property in question (a house) is real property, Lee could also claim a credit for tax paid to another treaty country in respect of his pre-emigration gain, if he lived in that other country. For example, if the house were located not in Treatyland but in Nontreatyland, Lee could – as a resident of Treatyland – claim a credit in respect of both Treatyland tax and Nontreatyland tax .*

New subsection 126(2.22) sets out a comparable rule in respect of distributions after October 1, 1996 by Canadian-resident trusts to non-resident individuals. While the general operation of this rule is very similar to that of new subsection 126(2.21), it should be noted that in this case the credit involves two taxpayers: foreign taxes paid by the beneficiary are creditable against Canadian taxes paid by the trust.

A consequential amendment to subsection 152(6) of the Act ensures that any necessary assessments of tax will be made in order to take account of the effect of new subsections 126(2.21) and (2.22).

New subsections 126(2.21) and (2.22) apply to the 1996 and subsequent taxation years.

### Where Foreign Credit Available

ITA
126(2.23)

New subsection 126(2.23) of the Act limits the availability of the new foreign tax credits under subsections 126(2.21) and (2.22). This rule requires that in computing, for the purposes of these new credits, the foreign tax an individual has paid in respect of the disposition of a property, the individual must first take into account any relevant tax credit (or other reduction in tax) that the individual is entitled to in respect of the property under the law of a foreign country or under a tax treaty between Canada and a foreign country. This is intended to ensure that the credits under new subsections 126(2.21) and (2.22) are only available to the extent that another country is not required to give credit for Canadian tax in respect of the disposition or a prior disposition of the property.

Subsection 126(2.23) applies to the 1996 and subsequent taxation years.

### Rules Relating to Unused Foreign Tax Credit

ITA
126(2.3)

Subsection 126(2.3) of the Act provides rules used to determine the unused foreign tax credit available for carryover to other taxation years. Consequential to the repeal of Part I.1, paragraphs 126(2.3)(*a*) and (*b*) are amended to remove the references to that Part, applicable to the 2001 and subsequent taxation years.

## Employees of International Organizations

ITA
126(3)

Subsection 126(3) of the Act provides a tax credit to Canadian-resident employees of international governmental organizations other than prescribed international governmental organizations. The amount of the credit is limited to the amount of any levy in lieu of taxes charged to the employee by the organization on the employee's remuneration.

The credit that may be claimed under subsection 126(3) is determined by multiplying the employee's Part I tax otherwise payable for a taxation year by a fraction. The numerator of that fraction, determined under paragraph 126(3)(*a*), consists of the employee's income for the year (or, where section 114 applies, for the period or periods in the year throughout which the employee is resident in Canada) from employment with the organization; the denominator of the fraction, determined under paragraph 126(3)(*b*), consists generally of the amount by which the employee's income for the year (or, where section 114 applies, for the period or periods in the year throughout which the employee is resident in Canada) exceeds the deductions listed in subparagraph 126(3)(*b*)(iii).

Subsection 126(3) is amended, with application to the 1998 and subsequent taxation years, to revise its references to section 114 of the Act to reflect changes to that section. For additional information, see the commentary on section 114.

## Portion of Foreign Tax Not Included

ITA
126(4)

Subsection 126(4) of the Act excludes from a taxpayer's creditable foreign taxes amounts that would not be imposed if the taxpayer were not entitled to a deduction under section 113 or section 126 of the Act. The subsection is amended to use the new defined term "government of a country other than Canada." (See the notes to amended subsection 126(6).)

This amendment, which makes no substantive change, applies after June 27, 1999.

## No Economic Profit

ITA
126(4.1)

Subsection 126(4.1), which limits a taxpayer's foreign tax credits in certain cases where there is no reasonable expectation of profit, is amended to use the newly defined term "government of a country other than Canada" (see the notes to amended subsection 126(6)), and to correct a minor drafting error in the English version.

This amendment, which makes no substantive change, applies after June 27, 1999.

## Dispositions Ignored

ITA
126(4.4)

Subsection 126(4.4) of the Act directs that certain dispositions and acquisitions of property be ignored for the purposes of the foreign tax credit limitations in subsections 126(4.1) and (4.2) of the Act. Paragraph 126(4.4)(*a*) is amended to add to this list dispositions and acquisitions under new subsections 10(12) and (13), 14(14) and (15) and 142.6(1.1) and (1.2) of the Act.

These amendments apply after June 27, 1999.

## Foreign Oil and Gas Levies

ITA
126(5)

Ordinarily, the only foreign taxes that may be credited against tax under Part I of the Act are income or profits taxes. Existing subsection 126(5) of the Act provides that a foreign tax may, subject to prescribed conditions, be deemed to be an income or profits tax. No such conditions are in place, and the subsection has no practical effect other than as a source of potential confusion. It is therefore replaced with a new and unrelated rule.

New subsection 126(5) of the Act, together with several new definitions added to subsection 126(7), treats certain levies imposed by a foreign government in connection with oil and gas businesses as income or profits taxes paid to the government.

These notes describe new subsection 126(5) and the new definitions in the order in which they will appear in the Act. However, because subsection 126(5) relies heavily on the new definitions, and because those definitions are themselves inter-related, readers may find that the best way to understand the provisions is to start by reviewing the definitions in the following order: "taxing country", "foreign oil and gas business", "commercial obligation", and "production tax amount", and only then to review new subsection 126(5).

These amendments (with the exception of the amendment to the definition "unused foreign tax credit" in subsection 126(7)) apply to taxation years that begin after December 31, 1999. However, if a taxpayer makes a written election to have these amendments apply to taxation years that begin after a designated date (which is earlier than December 31, 1999) and the election is filed with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which these amendments receive Royal Assent, these amendments apply to taxation years that begin after the later of:

(i) the date so designated by the taxpayer in the election; and

(ii) December 31, 1994.

The general effect of new subsection 126(5) of the Act is to treat a taxpayer's "production tax amount" as a foreign income or profits tax, subject to a maximum of 40 per cent of the taxpayer's income from the business in question. Specifically, where a taxpayer is resident in Canada throughout a taxation year and carries on a "foreign oil and gas business" in a "taxing country" in the year, new subsection 126(5) treats the taxpayer as having paid in the year to the government of the country, as an income or profits tax, the lesser of two amounts. The first amount, described in new paragraph 126(5)(*a*), is the amount by which 40 per cent of the taxpayer's income from the business in the country in the year exceeds the actual income and profits taxes (that is, those taxes determined without reference to this rule itself) paid in the year in respect of the business to the government of the country. The second amount, in new paragraph 126(5)(*b*), is the taxpayer's "production tax amount" for the business in the country in the year.

## Rules of Construction

ITA
126(6)

Subsection 126(6) of the Act confirms that foreign tax credits are computed on a country-by-country basis. This confirmation is preserved in new paragraph 126(6)(*b*), and the provision is expanded to include two other rules that apply for the purposes of section 126. First, new paragraph 126(6)(*a*) provides that the government of a country other than Canada includes the government of a state, province or other political subdivision of such a country. This new meaning allows several of the foreign tax credit rules to be simplified. Second, new paragraph 126(6)(*c*) provides that if income from a source in a country would be "tax-exempt income," but is not so only because part of the income is subject to tax, that part is deemed to be income from a separate source in the country. This rule, already found in subsection 126(8) of the Act, is simplified by the use of the new term set out in paragraph (*a*), and subsection 126(8) is consequently repealed.

These amendments apply after June 27, 1999.

## Definitions

ITA
126(7)

"business-income tax"
"economic profit"
"non-business-income tax"

The definitions "business-income tax", "economic profit", and "non-business-income tax" in subsection 126(7) of the Act are simplified through the use of the new term "government of a country other than

Canada." In addition, the language of the definition "business-income tax" is improved by replacing the term "any business" with the term "a business."

"commercial obligation"

A taxpayer who carries on a foreign oil and gas business in a country may simultaneously have more than one type of obligation to the government of the country or to an agent or instrumentality of that government. In the context of new subsection 126(5), which treats as foreign taxes certain amounts receivable by a foreign government, it is important to distinguish those obligations that can appropriately be treated as entailing income or profits taxes from those that are more in the nature of an ordinary commercial contract. The new definition "commercial obligation" describes the latter. A commercial obligation is one that the taxpayer has undertaken to a particular person, and that the law of the country would have allowed the taxpayer to undertake, on substantially the same terms, to a different person. (An obligation is not necessarily a commercial obligation, however, merely because it arises out of a contract.)

This new definition applies to taxation years that begin after 1999, subject to the election described in the notes to new subsection 126(5).

"foreign oil and gas business"

A taxpayer's foreign oil and gas business is a business the taxpayer carries on in a taxing country, the principal activity of which business is extracting petroleum, natural gas or related hydrocarbons from natural accumulations or from oil or gas wells.

This new definition applies to taxation years that begin after 1999, subject to the election described in the notes to new subsection 126(5).

"production tax amount"

The production tax amount of a taxpayer for a foreign oil and gas business carried on in a taxing country for a taxation year is the total of all amounts that meet the following four conditions.

First, the amounts must have become receivable in the year by the foreign country's government, because of the taxpayer's obligation (other than a commercial obligation) either to that government itself or to an agent or instrumentality of it.

Second, the amounts must be computed on a basis that takes into account the taxpayer's operating and capital costs. This does not mean that the computation must recognize all costs that would be deductible in computing the taxpayer's income for Canadian accounting or tax purposes. It means, rather, that the agreement or law that creates the obligation referred to above must allow for the deduction of some amount that is intended to account for the taxpayer's costs and that can reasonably be considered to have that effect.

Third, the amounts must not be income or profits taxes within the meaning of the Act read without reference to new subsection 126(5). Such taxes are already dealt with under the ordinary foreign tax credit rules, and need not be included in the taxpayer's production tax amount.

Finally, the amounts must not be identified as royalties, either in an agreement that creates the obligation or under the foreign country's law. Royalties are inherently not income or profits taxes, and it is not appropriate that any amount that is explicitly described as a royalty be indirectly characterized as an income tax by being included in the production tax amount.

"tax for the year otherwise payable under this Part"

One of the limitations on the amount of a taxpayer's foreign tax credits for a taxation year is based on a proportion of the amount of Canadian tax that the taxpayer would otherwise pay for the year. The definition "tax for the year otherwise payable under this Part" sets out three variants of that amount, for use in different contexts. As a consequence of the introduction of new section 123.4 of the Act, each of those variants is modified to ensure that the amounts determined under the definition do not reflect the deductions from tax provided in new section 123.4, and thus that a corporation's foreign tax credits are not inappropriately reduced. Minor clarifying improvements are also made to the text of the definition.

This amended definition applies to the 2001 and subsequent taxation years.

"qualifying incomes"
"qualifying losses"

For commentary on the amendments to these two definitions, see the commentary on new subsection 126(9) of the Act.

This new definition applies to taxation years that begin after 1999, subject to the election described in the notes to new subsection 126(5).

"taxing country"

New subsection 126(5) in effect treats as income taxes certain levies imposed on a Canadian resident who carries on an oil or gas business in a foreign country. In order for the subsection to apply, the country in question must be one that regularly imposes an income tax on other business income. The definition "taxing country" incorporates this principle: a taxing country is one whose government regularly imposes, in respect of business income, a levy or charge of general application that is (without reference to subsection 126(5)) an income or profits tax.

This new definition applies to taxation years that begin after 1999, subject to the election described in the notes to new subsection 126(5).

"unused foreign tax credit"

Consequential to the repeal of Part I.1 of the Act, this definition is amended to remove the references to that Part, applicable to the 2001 and subsequent taxation years.

These amendments, which make no substantive change, apply after June 27, 1999.

## Calculation of Foreign Tax Credit

ITA
126(9)

Subsection 126(1) of the Act sets out the rules for claiming a credit in respect of foreign taxes on non-business income (that is, the foreign taxes imposed on investment income and other categories of foreign source non-business income). A credit in respect of foreign taxes on business income is provided under subsection 126(2). Neither credit may exceed the Canadian tax otherwise payable in respect of the foreign source income. Canadian tax otherwise payable on foreign source income is generally determined by reference to the ratio of the net income from sources in a foreign country to total income. The net foreign source income is the amount, if any, by which "qualifying incomes" (as defined in subsection 126(7)) from those sources exceeds "qualifying losses" (as defined in the same subsection) from those sources.

The definitions "qualifying income" and "qualifying losses" are amended such that all the rules for determining those amounts are included in new subsection 126(9) – rather than in the body of the definitions – and that the definitions contain references to that subsection.

New subsection 126(9) sets out the amended rules for determining "qualifying incomes" and "qualifying losses". These amended rules consist of the existing rules (that is, those rules that are found in the body of the existing definitions) as well as certain new additional rules. These additional rules relate to deductions under certain provisions of the Act (in these notes referred to as the "particular resource deduction provisions"), namely subsections 66(4) and 66.7(2) and new subsections 66.21(4) and 66.7(2.3) of the Act. Under these additional rules, the qualifying incomes and qualifying losses for a taxation year of a taxpayer from sources in a country are determined as if such portion of the total amount deducted under the particular resource deduction provisions as applies to those sources were the greater of:

- the total amount actually deducted in respect of those sources under the particular resource deduction provisions; and

- the maximum amount that would be deductible in respect of those sources under the particular resource deduction provisions if specified assumptions were made. These assumptions, in general terms, ignore the taxpayer's income from other sources.

This amendment applies to taxation years that begin after December 31, 1999. However, if a taxpayer makes a written election to have this amendment apply to taxation years that begin after a designated date (which is earlier than December 31, 1999) and the election is filed with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day on which this amendment receives royal assent, the amendment applies to taxation years that begin after the later of:

(i) the date so designated by the taxpayer in the election; and

(ii) December 31, 1994.

## Clause 118

## Investment Tax Credit

ITA
127

Section 127 of the Act includes a set of provisions governing a taxpayer's entitlement to claim an investment tax credit (ITC).

ITA
127(5)

Subsection 127(5) of the Act provides for the deduction of investment tax credits from a taxpayer's Part I (and, for taxation years before 2001, Part I.1) tax otherwise payable for a taxation year. The term "investment tax credit" is defined in subsection 127(9) of the Act.

Subparagraph 127(5)(*a*)(i) provides that the taxpayer's investment tax credit at the end of the year in respect of property acquired before the end of the year or of the taxpayer's SR&ED qualified expenditure pool at the end of the year or of a preceding taxation year may be deducted in computing the taxpayer's tax payable for the year under

Part I of the Act. For the 2000 and subsequent taxation years, subparagraph 127(5)(*a*)(i) is amended to ensure that the taxpayer's investment tax credit at the end of the year in respect of the taxpayer's flow-through mining expenditure for the year or a preceding taxation year may also be deducted in computing the taxpayer's tax payable for the year. The new term "flow-through mining expenditure" is added to the definitions in subsection 127(9).

Clause 127(5)(*a*)(ii)(A) provides that the taxpayer's investment tax credit at the end of the year in respect of property acquired in a subsequent taxation year or of the taxpayer's SR&ED qualified expenditure pool at the end of a subsequent taxation year may be deducted in computing the taxpayer's tax payable for the year. For the 2000 and subsequent taxation years, clause 127(5)(*a*)(ii)(A) is amended to ensure that the investment tax credit in respect of the taxpayer's flow-through mining expenditure for a subsequent year may also be deducted in computing the taxpayer's tax payable under Part I. The new term "flow-through mining expenditure" is added to the definitions in subsection 127(9).

Consequential to the repeal of Part I.1 of the Act (i.e., the provisions relating to the individual surtax) for the 2001 and subsequent taxation years, the reference, in clause 127(5)(*a*)(ii)(A), to subsection 180.1(1.2) is removed for the 2001 and subsequent taxation years. For details concerning the repeal of Part I.1, refer to the commentary on Part I.1.

Paragraph 127(5)(*b*) describes an amount that may be deducted for a taxation year by a taxpayer where the taxpayer is subject to the minimum tax for the year. Consequential to the repeal of Part I.1 of the Act (i.e., the provisions relating to the individual surtax) for the 2001 and subsequent taxation years, paragraph 127(5)(*b*) is amended to remove the reference to subsection 180.1(1.2) for those years. For details concerning the repeal of Part I.1, refer to the commentary on Part I.1.

**Definitions**

ITA
127(9)

Subsection 127(9) of the Act provides definitions that are used in the provisions that relate to investment tax credits.

"investment tax credit"

The definition "investment tax credit" in subsection 127(9) of the Act provides for the determination of a taxpayer's investment tax credit (ITC) at the end of a taxation year.

Paragraph (*a*.1) of the definition "investment tax credit" in subsection 127(9) is amended to require taxpayers to reduce the base on which the investment tax credit (ITC) is computed. Existing paragraph (*a*.1) of the definition requires the inclusion of 20% of the taxpayer's scientific research and experimental development (SR&ED) qualified expenditure pool for a year in the taxpayer's ITC. New paragraph (*a*.1) of the definition requires the inclusion of 20% of the amount by which a corporation's SR&ED qualified expenditure pool for a year exceeds the corporation's super-allowance benefit amount for each province to which it applies. See the commentary below on the new definition "super-allowance benefit amount".

The amendment to paragraph (*a*.1) of the definition "investment tax credit" applies to taxation years that begin after February 2000 except that, for corporations whose first taxation year that begins after February 2000 ends before 2001, the amendment applies to taxation years that begin after 2000.

New paragraph (*a*.2) of the definition provides that, where the taxpayer is an individual (other than a trust), 15% of the taxpayer's flow-through mining expenditures at the end of a taxation year is added to the taxpayer's ITC at the end of the year. (The new expression "flow-through mining expenditure" is added to the definitions in subsection 127(9). See the commentary below for further details.)

Paragraph (*c*) of the definition of "investment tax credit" provides for a three-year carryback and ten-year carryforward of unused ITCs in respect of which an amount is determined under paragraph (*a*), (*a*.1) or (*b*) of that definition. Paragraph (*c*) of the definition is amended to add a reference to new paragraph (*a*.2) to ensure that amounts determined in respect of paragraph (*a*.2) have the same carryover period.

These amendments to the definition "investment tax credit" generally apply after October 17, 2000.

Paragraph (*l*) of the definition "investment tax credit" is also amended. It was originally added by S.C. 1998, c. 19, ss. 33(1) [formerly Bill C-28] as part of amendments to exclude from that definition expenditures in respect of which a taxpayer has not filed a prescribed form with Revenue Canada within one year after the taxpayer's filing-due date for the taxation year in which the expenditure was incurred. That amendment, which applied to all taxation years, incorrectly replaced the reference to "income exempt from tax under this Part" in the former "post-amble" to the definition "investment tax credit" with the concept "exempt income" in paragraph (*l*). The phrase "income exempt from tax under this Part" excluded from the definition of "investment tax credit" amounts incurred by a person whose taxable income is exempt from tax, as well as income that is exempt income for the purpose of calculating income under section 3 of the Act. Paragraph (*l*) of the definition "investment tax credit" is amended to correct this oversight, applicable to all taxation years.

"flow-through mining expenditure"

The term "flow-through mining expenditure" is added to subsection 127(9) of the Act to define an expenditure that qualifies for the 15% investment tax credit, available to a taxpayer who is an individual (other than a trust), as provided for in new paragraph (*a*.2) of the definition "investment tax credit" in subsection 127(9). See the commentary on the definition "investment tax credit" for further details.

A flow-through mining expenditure of a taxpayer for a taxation year generally means an expense that is considered by the Act to have been incurred by the taxpayer in the year as a result of a renunciation by a corporation under an agreement for the issue of a flow-through share (this expense being referred to in this commentary as an "investor mining expense") and that meets certain additional conditions set out in paragraphs (*a*) to (*e*) of the definition "flow-through mining expenditure".

The term "flow-through share" is defined in subsection 66(15) of the Act. A flow-through share is generally a share of the capital stock of a principal-business corporation that is issued to a person pursuant to an agreement in writing under which the corporation agrees to incur resource expenses and to renounce those expenses to that person. The term "principal-business corporation" is also defined for these purposes in subsection 66(15). A principal-business corporation for these purposes is generally a corporation the principal business of which is exploration and development of minerals or other resources. Subsection 66(12.6) of the Act permits such a principal-business corporation to renounce its Canadian exploration expenses (CEE) to its flow-through shareholders. In general, where a corporation renounces CEE to a shareholder under subsection 66(12.6), the shareholder is deemed by subsection 66(12.61) to have incurred CEE on the effective date of the renunciation.

In some cases, the agreement for the issue of the flow-through share is between the renouncing corporation and a partnership. Paragraph (*h*) of the definition "Canadian exploration expense" in subsection 66.1(6) of the Act provides, in general, that the taxpayer's share of any CEE actually incurred (or deemed incurred) in a fiscal period by a partnership is considered to be CEE of the taxpayer, if at the end of that fiscal period the taxpayer is a member of the partnership. Under subsection 66(18) of the Act, the taxpayer's CEE is deemed to have been incurred at the end of that fiscal period.

An investor mining expense incurred by a taxpayer in a taxation year is an expense deemed incurred by a taxpayer in the year because of

- subsection 66(12.61)

  (i.e., the case where the agreement for the issue of the flow-through share is between the renouncing corporation and the taxpayer)

or

- subsection 66(18) as a consequence of the application of subsection 66(12.61) to the partnership of which the taxpayer is a member

> (i.e., the case where the agreement for the issue of the flow-through share is between the renouncing corporation and a partnership of which the taxpayer is a member).

An investor mining expense incurred by a taxpayer in a taxation year is a "flow-through mining expenditure" of a taxpayer for the year if the expense meets the requirements set out in paragraphs (*a*) to (*e*) of the definition "flow-through mining expenditure" and discussed below.

Paragraph (*a*) of the definition "flow-through mining expenditure" requires that the expense be a CEE incurred after October 17, 2000 and before 2004 by a corporation in conducting mining exploration activity from or above the surface of the earth for the purpose of determining the existence, location, extent or quality of a mineral resource described in paragraph (*a*) or (*d*) of the definition "mineral resource" in subsection 248(1) of the Act.

Paragraph (*b*) of the definition "flow-through mining expenditure" requires that the expense be an expense that

> (i) is an expense described in paragraph (*f*) of the definition "Canadian exploration expense" in subsection 66.1(6), and
>
> (ii) is not an expense in respect of
>
> > (A) trenching, if one of the purposes of the trenching is to carry out preliminary sampling (other than specified sampling),
> >
> > (B) digging test pits (other than digging test pits for the purpose of carrying out specified sampling), and
> >
> > (C) preliminary sampling (other than specified sampling).

The definition "specified sampling" is added to subsection 127(9). See the commentary on that definition for further details.

Paragraph (*c*) of the definition "flow-through mining expenditure" requires that the agreement described in subsection 66(12.6) of the Act between the renouncing corporation and the flow-through shareholder be made after October 17, 2000.

Paragraph (*d*) of the definition "flow-through mining expenditure" contemplates the possibility that expenses renounced by the corporation to the taxpayer (or to a partnership of which the taxpayer is a member) were not actually incurred by the corporation. This is possible where expenses are deemed to have been incurred by the corporation as a result of a renunciation by another corporation under subsection 66(12.6) of the Act (referred to in this commentary as the "prior renunciation") to the corporation. Paragraph (*d*) requires that in these cases the prior renunciation be made under an agreement that is described in subsection 66(12.6) and is made between the corporations after October 17, 2000.

Paragraph (*e*) of the definition "flow-through mining expenditure" contemplates the effect of subsection 66(12.66) of the Act on the timing of expenses. As described above, paragraph (*a*) requires that the expense be incurred by the corporation before 2004. Subsection 66(12.66) deals with certain types of resource expenses and generally allows a corporation to renounce, effective on the last day of the preceding calendar year, resource expenses that the corporation intends to incur in the current calendar year. In the absence of paragraph (*e*), expenses incurred by the corporation in 2004 and deemed by subsection 66(12.66) to have been incurred by the corporation in 2003 might otherwise meet the pre-2004 test in paragraph (*a*). Accordingly, paragraph (*e*) requires that the expense be an expense that would be incurred by the corporation before 2004 if the Act were read without reference to subsection 66(12.66).

The new definition "flow-through mining expenditure" applies after October 17, 2000.

"specified sampling"

The expression "specified sampling" is relevant for the new definition "flow-through mining expenditure" in subsection 127(9).

The expression "specified sampling" is defined as the collecting and testing of samples in respect of a mineral resource, except that specified sampling does not include

> (*a*) the collecting or testing of a sample that, at the time the sample is collected, weighs more than 15 tonnes, and
>
> (*b*) the collecting or testing of a sample collected at any time in a calendar year in respect of a mineral resource if the total weight of all samples collected (by any person or partnership or any combination of persons and partnerships) in the calendar year and before that time (other than samples each of which weighs less than one tonne) in respect of that resource exceeds 1,000 tonnes.

The new definition "specified sampling" applies after October 17, 2000.

"super-allowance benefit amount"

The "super-allowance benefit amount" of a corporation for a taxation year is calculated by reference to the formula (A - B) x C. The factor (A - B) describes the amount by which a provincial income tax deduction exceeds the SR&ED expenditure otherwise determined (without reference to provincial income tax credits). Variable C is the provincial rate of tax to be applied to convert the excess deduction into a tax-credit equivalent. For corporations with an expenditure limit for the year for SR&ED purposes (as determined under subsection 127(10.2)) that is greater than nil, the applicable tax rate for variable C is the rate that the province applies to small business income earned in the year. Where the taxpayer's expenditure limit is nil, the applicable rate is the general corporate income tax rate for the year in the province for active business income.

The new definition "super-allowance benefit amount" applies to taxation years that begin after February 2000 except that, for corporations whose first taxation year that begins after February 2000 ends before 2001, the amendment applies to taxation years that begin after 2000.

ITA
127(10.1)

Subsection 127(10.1) of the Act provides an additional 15% ITC to Canadian-controlled private corporations, based on the least of the amount that the corporation claims (paragraph 127(10.1)(*a*)), the corporation's SR&ED qualified expenditure pool for the year (paragraph 127(10.1)(*b*)) and the corporation's expenditure limit for the year (paragraph 127(10.1)(*c*)). Subsection 127(10.1) is amended to reduce the amount determined under paragraph 127(10.1)(*b*) by the taxpayer's super-allowance benefit amount for the year for each province to which it applies.

This amendment applies to taxation years that begin after February 2000 except that, for corporations whose first taxation year that begins after February 2000 ends before 2001, this amendment applies to taxation years that begin after 2000.

ITA
127(11.1)

Subsection 127(11.1) of the Act sets out various rules for determining amounts to be included for the purpose of the definition "investment tax credit" in subsection 127(9) of the Act. These rules provide for the reduction of capital cost and qualified expenditures by certain amounts that qualify as assistance or contract payments.

New paragraph 127(11.1) (*c*.2) reduces a taxpayer's "flow-through mining expenditure" (as newly defined in subsection 127(9)) by the amount of assistance that the taxpayer has received, is entitled to receive or can reasonably be expected to receive relating to expenses included in determining the taxpayer's flow-through mining expenditure.

The amendments to subsections 127(5) and (11.1) apply to the 2000 and subsequent taxation years.

The amendment to subsection 127(9) applies after October 17, 2000.

## Clause 119

### Minimum Tax

ITA
127.52

Section 127.52 of the Act defines the "adjusted taxable income" of an individual for a taxation year for the purpose of determining the individual's minimum tax liability under Part I of the Act.

### Adjusted Taxable Income Determined

ITA
127.52(1)(*d*) to (*e*.1)

Subsection 127.52(1) of the Act defines an individual's adjusted taxable income for a taxation year for the purpose of determining the individual's minimum tax liability under Part I of the Act, and generally requires that the portion of capital gains that is not included in income, because of the inclusion rate, be added in computing adjusted taxable income.

Paragraph 127.52(1)(*d*) is amended to require that 4/5, in total, only of realized capital gains (subparagraph 127.52(1)(*d*)(i) and gains allocated from a trust (127.52(1)(*d*)(ii)) need to be included in compiling adjusted taxable income.

The amendments are consequential to the reduction of the inclusion rate from 3/4 to 1/2 and generally apply to the 2000 and subsequent taxation years.

Paragraph 127.52(1)(*e*) provides that "adjusted taxable income" is computed on the assumption that the total of specified resource-related deductions does not exceed specified resource income. Paragraph 127.52(1)(*e*.1) provides that "adjusted taxable income" is computed on the assumption that financing expenses deductible under paragraphs 20(1)(*c*) to (*f*) in respect of the acquisition of flow-through shares, Canadian resource properties or foreign resource properties do not exceed the amount by which the same specified resource income exceeds the same specified resource-related deductions.

Paragraphs 127.52(1)(*e*) and (*e*.1) are amended so that the resource-related deductions so specified include the deduction under new subsection 66.21(4).

These amendments apply to taxation years that begin after 2000.

ITA
127.52(1)(*g*)

Paragraph 127.52(1)(*g*) of the Act provides that, for the purpose of computing the adjusted taxable income of a trust for a year, the non-taxable portion of certain net taxable capital gains of the trust is to be deducted. These net taxable capital gains are those designated by the trust under subsection 104(21), those included by virtue of subsection 104(13) or section 105 of the Act in computing the income of a non-resident beneficiary and those paid to a beneficiary by a trust governed by an employee benefit plan. In each of those cases, the trust may deduct the amount of the net taxable capital gain (i.e., 1/2 of the gain) in computing its income. The amendment provides that an additional 3/5 of such net taxable capital gains may be deducted by the trust, to fully off set the 80 per cent inclusion under subparagraph 127.52(1)(*d*)(ii).

This amendment is consequential to the reduction to 80 per cent from 100 per cent of the inclusion of capital gains for minimum tax purposes.

ITA
127.52(1)(*h*)

Paragraph 127.52(1)(*h*) of the Act provides that only certain deductions under sections 110 to 110.7 of the Act may be taken into account in computing an individual's adjusted taxable income for minimum tax purposes.

Paragraph 127.52(1)(*h*) is amended to include, in the deductions that may be taken into account in determining adjusted taxable income for 2000 and subsequent taxation years, a portion of the amounts deducted under paragraphs 110(1)(*d*) and (*d*.1) to (*d*.3) of the Act and the full amount of any deduction claimed under new paragraph 110(1)(*d*.01) of the Act.

- Paragraphs 110(1)(*d*), (*d*.01) and (*d*.1) provide for deductions in respect of taxable employment benefits ("stock option benefits") that an individual is deemed by section 7 of the Act to have received in connection with the exercise or disposition of rights to acquire securities under an employee option agreement.

- Paragraph 110(1)(*d*.2) provides a deduction in respect of amounts that a prospector or grubstaker is required to include in income under paragraph 35(1)(*d*) with respect to shares acquired in exchange for an interest in a mining property.

- Paragraph 110(1)(*d*.3) provides a deduction in respect of certain amounts that an individual is required to include in income when disposing of shares received as part of a lump sum payment on ceasing to participate in a deferred profit sharing plan.

Generally speaking, the effect of the deductions under paragraphs 110(1)(*d*) to (*d*.3) is to tax the related income inclusion at rates equivalent to capital gains. Similarly, the changes to the calculation of adjusted taxable income will result in recognition of the relevant deductions in a manner equivalent to capital gains for minimum tax purposes.

As amended, paragraph 127.52(1)(*h*) allows 2/5 of the deductions under paragraphs 110(1)(*d*.1), (*d*.2) and (*d*.3) to be taken into account in determining adjusted taxable income. Thus, when the deduction under those paragraphs is 1/2, the net result is to include only 80% of the related taxable amount in adjusted taxable income.

As amended, paragraph 127.52(1)(*h*) also allows 2/5 of the deductions under paragraph 110(1)(*d*) to be taken into account in determining adjusted taxable income. However, if the individual makes a charitable donation of the employee option security to which the deduction under paragraph 110(1)(*d*) relates and claims a deduction under paragraph 110(1)(*d*.01), the full amount of the deduction under paragraph 110(1)(*d*) may generally be taken into account in computing adjusted taxable income, as well as the full amount of the deduction under paragraph 110(1)(*d*.01).

***Example 1***

*In June 2001, Gerard exercises options to acquire 100 shares of his corporate employer for $10 a share. The fair market value (FMV) at that time is $110 a share. The taxable stock option benefit is $100 a share, or $10,000 in total. He is entitled to a deduction under paragraph 110(1)(d) of $5,000 (= 1/2 of $10,000).*

*Immediately, Gerard donates the shares to charity. He is entitled to a deduction under paragraph 110(1)(d.01) of $2,500 (= 1/4 of (100 x ($110 - $10))). Thus, the net amount of the stock option benefit that is subject to taxation is $2,500 (= $10,000 - $5,000 - $2,500).*

*In computing adjusted taxable income, Gerard may fully deduct the $2,500 that is deducted under paragraph 110(1)(d.01). In addition, he may fully deduct the $5,000 deducted under paragraph 110(1)(d). Thus, the net amount of the stock option benefit that is included in computing adjusted taxable income is also $2,500 (= $10,000 - $2,500 - $5,000).*

Similarly, if instead of donating the security, the individual sells the security and donates the proceeds from the disposition of the security and claims a deduction under paragraph 110(1)(*d*.01), the full amount of the deduction under paragraph 110(1)(*d*) may generally be taken into account in computing adjusted taxable income, as well as the full amount of the deduction under paragraph 110(1)(*d*.01).

***Example 2***

*The facts are the same as in Example 1 except that, instead of donating the shares, Gerard directs the stock option plan administrator to sell the shares and donate the proceeds to charity.*

*By virtue of subsection 110(2.1), he is entitled to a deduction under paragraph 110(1)(d.01) of $2,500. The net amount of the stock option benefit that is subject to taxation is $2,500. Likewise, the net amount of the stock option benefit that is included in adjusted taxable income is $2,500.*

If, in the case of a donation of an employee option security to charity, the value of the security is less at the time of donation than at the time of acquisition, only that portion of the deduction under paragraph 110(1)(*d*) that would have been deductible if the value of the security at the time of acquisition were the lesser value will be fully deductible in computing adjusted taxable income, while the remainder will be deductible at a rate of 2/5.

***Example 3***

*The facts are the same as in Example 1 except that Gerard does not donate the shares immediately. By the time the shares are donated, the FMV has dropped to $90 a share. Thus, he is entitled to a deduction under paragraph 110(1)(d.01) of $2,000 (= 1/4 of (100 x ($90 - $10))), and the net amount of the stock option benefit that is subject to taxation is $3,000 (= $10,000 - $5,000 - $2,000).*

*In computing adjusted taxable income, Gerard may fully deduct the $2,000 that is deducted under paragraph 110(1)(d.01). In addition, he may fully deduct the portion of the amount that would have been deducted under paragraph 110(1)(d) if the per-share stock option benefit had been $80 (= $90 - $10) rather than $100. In other words, in computing adjusted taxable income, he may fully deduct $4,000 of the $5,000 deducted under paragraph 110(1)(d). Also, he may deduct 2/5 of the remainder of the deduction under paragraph 110(1)(d), or $400 (= 2/5 of ($5,000 - $4,000)). Thus, the net amount of the stock option benefit that is included in computing adjusted taxable income is $3,600 (= $10,000 - $2,000 - $4,000 - $400).*

Similarly, if an employee option security is sold and only part of the proceeds are donated, only a pro-rata portion of the deduction under paragraph 110(1)(*d*) will be fully deductible in computing adjusted taxable income, while the remainder will be deductible at a rate of 2/5.

***Example 4***

*The facts are the same as in Example 2 except that, instead of donating the full proceeds of disposition, Gerard directs the plan*

> *administrator to pay $1,000 to the employer to cover the exercise price and to donate the remaining $10,000.*
>
> *By virtue of subsection 110(2.1), he is entitled to a deduction under paragraph 110(1)(d.01) of $2,273 (= ($2,500 x ($10,000/$11,000)). The net amount of the stock option benefit that is subject to taxation is $2,727.*
>
> *In computing adjusted taxable income, Gerard may fully deduct the $2,273 claimed under paragraph 110(1)(d.01). In addition, he may fully deduct a pro-rata portion of the $5,000 deducted under paragraph 110(1)(d), which is $4,545 (= $5,000 x ($10,000/$11,000)). Finally, he may deduct 2/5 of the remainder of the deduction under paragraph 110(1)(d), which is $182 (= 2/5 of ($5,000 - $4,545). Thus, the net amount of the stock option benefit that is included in computing adjusted taxable income is $3,000 (= $10,000 - $2,273 - $4,545 - $182).*

Mechanically, subparagraph 127.52(1)(*h*)(ii) provides for the appropriate portion of the deduction under paragraph 110(1)(*d*) to be taken into account in determining adjusted taxable income by allowing the deduction to be taken into account, but subject to a limit equal to the total of

(A) twice the amount deducted under paragraph 110(1)(*d*.01), and

(B) 2/5 of the excess of the amount deducted under paragraph 110(1)(*d*) over the amount determined under (A).

For benefits realized before October 18, 2000, the amount included in (A) is the amount deducted under paragraph 110(1)(*d*.01), rather than twice that amount. This reflects the fact that, for those benefits, the deductions under both paragraphs 110(1)(*d*) and (*d*.01) would have been at the rate of 1/3 of the stock option benefit – rather than at the rates of 1/2 and 1/4 that apply under those paragraphs, respectively, for benefits realized after October 17, 2000.

This mechanical calculation is demonstrated in the following example.

***Example 5***

*The facts are the same as in example 4. In applying paragraph 127.52(1)(h), subparagraph (ii) provides that the deduction under paragraph 110(1)(d) may be taken into account but that it is limited to $4,728, which is calculated as follows:*

> *(A) twice the amount deducted under paragraph 110(1)(d.01), which is $4,546 (= 2 x $2,273)*

*plus*

> *(B) 2/5 of the amount deducted under paragraph 110(1)(d) less the amount determined under (A) above, which is $182 (= 2/5 x ($5,000 - $4,546))*

*Consequently, the net amount of the stock option benefit that is included in adjusted taxable income is $2,999 (= $10,000 - $4,728 - $2,273). (The difference from the result in Example 4 is due to rounding.)*

## Clause 120

## Foreign Tax Credit – Minimum Tax

ITA
127.54(2)(*b*)(ii)

Section 127.54 of the Act provides for a special foreign tax credit in computing an individual's minimum tax. This special credit is equal to the lesser of 17 per cent of the individual's foreign income and the foreign tax paid in respect of that income. Subparagraph 127.54(2)(*b*)(ii), is amended to replace the reference to "17%" with a reference to "16%". The amendment is consequential to the reduction from 17 to 16 per cent of the lowest income tax rate for individuals, which is also the rate applicable for minimum tax purposes.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 121

### Application of Section 127.5

ITA
127.55

Section 127.55 of the Act limits the application of the alternative minimum tax set out in section 127.5 of the Act. Paragraph 127.55(b) refers to existing section 119. Existing section 119 is no longer active, and is replaced with a new, unrelated rule. Paragraph 127.55(b) is therefore repealed, for the 1996 and subsequent taxation years.

## Clause 122

### Where Individual Bankrupt

ITA
128(2)(*e*) and (*f*)

Subsection 128(2) of the Act contains rules that apply to individuals who become bankrupt.

Paragraph 128(2)(*e*) requires a trustee in bankruptcy to file, for each taxation year in the calendar year in which an individual becomes bankrupt, an income tax return with respect to certain income of the estate and businesses of the individual. For this purpose, the individual's income is to be determined as if no deductions other than those specifically listed were available to the individual.

Paragraph 128(2)(*e*) is amended to include in the list of allowable deductions a deduction under new paragraph 110(1)(*d*.01) of the Act. Paragraph 110(1)(*d*.01) allows a deduction where certain employee option securities (or proceeds from the disposition of such securities) are donated to a qualifying charity. This deduction is available to the extent that the securities option benefit to which the deduction relates is included in computing the individual's taxable income for the taxation year for which the return is being filed.

Paragraph 128(2)(*f*) requires an individual who is bankrupt at any time in a taxation year to file an income tax return for the year, in addition to the return required under paragraph 128(2)(*e*) to be filed by the trustee in bankruptcy. For this purpose, the individual's income is to be determined as if certain listed deductions were not available.

Paragraph 128(2)(*f*) is amended to include in the list of deductions that are not available a deduction under new paragraph 110(1)(*d*.01).

These amendments apply to the 2000 and subsequent taxation years.

## Clause 123

## Changes in Residence

ITA
128.1

Section 128.1 of the Act sets out the income tax effects of becoming or ceasing to be resident in Canada. The present amendments make several important additions to section 128.1, including:

- a more comprehensive deemed disposition of property by individual emigrants;
- greater clarity as to the exclusion of certain pension and other rights from the deemed dispositions on emigration and immigration;
- special accommodation of individuals (other than trusts) who, having emigrated from Canada, re-establish residence in Canada;
- the ability for post-emigration losses in effect to reduce gains realized as a result of the deemed disposition on emigration;
- information reporting requirements for individuals who emigrate from Canada; and

- in certain circumstances, a deemed end to the fiscal period of a business carried on by an individual emigrant.

In addition, these amendments make a number of clarifying and updating changes to section 128.1. They also revise the section as necessary to reflect other amendments such as the restructured definition "taxable Canadian property" and the changes to section 114 of the Act.

## Immigration

ITA
128.1(1)(*b*)(i)

Subsection 128.1(1) of the Act sets out rules that apply where a taxpayer becomes resident in Canada. Paragraph 128.1(1)(*b*) treats a taxpayer who becomes resident in Canada as having disposed of the taxpayer's property, with certain exceptions, for proceeds equal to the property's fair market value. This disposition is deemed to have taken place immediately before the time that is immediately before the time at which the taxpayer becomes resident.

The properties excluded from the deemed disposition on immigration under paragraph 128.1(1)(*b*) are essentially those properties that were, ignoring any relevant tax treaty, already subject to tax in Canada. Subparagraph 128.1(1)(*b*)(i) sets out one type of excluded property, being taxable Canadian property. Subparagraph 128.1(1)(*b*)(i) is amended, with application after October 1, 1996, to simplify its description of taxable Canadian property. This change is a consequence of the relocation of the main definition of taxable Canadian property to subsection 248(1) of the Act.

ITA
128.1(1)(*b*)(iv) and (v)

As described above, paragraph 128.1(1)(*b*) of the Act provides for a deemed disposition of most properties owned by a taxpayer who becomes resident in Canada. Subparagraph 128.1(1)(*b*)(iv) excludes from this deemed disposition property that was the subject of an election under existing subparagraph 128.1(4)(*b*)(iv) of the Act – an election not to be treated as having disposed of the property on an earlier emigration from Canada. One of the effects of having made the election is that the property is deemed to be taxable Canadian property, which in any case is (as a result of subparagraph 128.1(1)(*b*)(i)) excluded from the deemed disposition on immigration. The current version of subparagraph 128.1(1)(*b*)(iv) is thus not necessary, and can be replaced with a different rule.

New subparagraph 128.1(1)(*b*)(iv) excludes from the deemed disposition on immigration any property (other than an interest acquired for no consideration in a non-resident testamentary trust) that is an "excluded right or interest" of the taxpayer. As defined in new subsection 128.1(10) of the Act, the term "excluded right or interest" includes many kinds of income rights and other properties. Since the term also encompasses rights under agreements referred to in subsections 7(1) and 7(1.1) of the Act (options of employees to acquire shares of a corporation or units of a mutual fund trust), existing subparagraph 128.1(1)(*b*)(v), which refers only to employee stock options, is unnecessary and is repealed.

These changes apply to changes in residence that occur after October 1, 1996.

**Fiscal Period**

ITA
128.1(4)(*a*.1)

Subsection 128.1(4) sets out rules that apply where a taxpayer ceases to be resident in Canada. New paragraph 128.1(4)(*a*.1) provides that the fiscal period of any business carried on by an individual emigrant (other than a trust), otherwise than through a permanent establishment in Canada, is deemed to have ended immediately before the emigration time and a new fiscal period of the business is deemed to have begun at the emigration time. This ensures the appropriate measurement of the individual's pre-departure income or loss from the business. The paragraph, which applies to changes in residence after October 1, 1996, also allows the emigrant to choose a new fiscal period of the business.

**Deemed Disposition**

ITA
128.1(4)(*b*)

Paragraph 128.1(4)(*b*) treats a taxpayer who ceases to be resident in Canada as having disposed of the taxpayer's property, for proceeds equal to fair market value. This disposition is deemed to have taken place at a "time of disposition" that is immediately before the time that is immediately before the time the taxpayer ceases to be resident. The time of cessation of residence is referred to in the provision as the "particular time" and in these notes as the "emigration time."

Where the taxpayer is an individual, certain types of property are exempted from the deemed disposition. These properties, generally, are those that would be subject to Canadian taxation in the hands of a non-resident.

Paragraph 128.1(4)(*b*) is amended to ensure that this policy is better reflected in the legislation. Under amended paragraph 128.1(4)(*b*), an individual emigrant from Canada is treated as having disposed of all property other than:

(i) real property situated in Canada, Canadian resource properties and timber resource properties;

(ii) property of a business carried on by the individual, at the emigration time, through a permanent establishment in Canada – including capital property, eligible capital property and property described in the inventory of the business;

(iii) property that is an "excluded right or interest" of the individual. As defined in new subsection 128.1(10) of the Act, the term "excluded right or interest" includes many kinds of income rights and other properties. See the commentary on new subsection 128.1(10) for more details;

(iv) certain property of short-term residents (see below); and

(v) certain property of a short-term non-resident (see the commentary on new subsection 128.1(6) of the Act).

Since the definition "excluded right or interest" in new subsection 128.1(10) encompasses rights under agreements referred to in subsections 7(1) and 7(1.1) of the Act (options of employees to acquire shares of a corporation or units of a mutual fund trust), existing subparagraph 128.1(4)(*b*)(vi), which refers only to employee stock options, is unnecessary and is repealed.

Under new subparagraph 128.1(4)(*b*)(iv), an individual (other than a trust) who has been resident in Canada for 60 months or less during the 10-year period preceding the cessation of residence is not deemed to dispose of any property that the individual owned on becoming resident in Canada, or that the individual inherited after becoming resident here. (This exception was formerly provided under subparagraph 128.1(4)(*b*)(v) of the Act.)

Where an individual (other than a trust) ceases to be resident in Canada after October 1, 1996 and re-establishes Canadian residence at a later time, a special rule, set out in new subsection 128.1(6), enables the individual to exclude all property from the deemed disposition in respect of the cessation of residence. For additional information, see the commentary on subsection 128.1(6).

Two additional points should be noted. First, where an emigrating individual owns shares of a corporation which owns a life insurance policy under which the individual's life is insured, upon the deemed disposition at departure of the individual's shares in the corporation, a special rule contained in amended subsection 70(5.3) of the Act will be used in the valuation of the corporation's shares – the cash surrender value of the life insurance policy owned by the corporation will be treated as the fair market value of that policy. Second, the *Income Tax Regulations* will be amended after these amendments receive Royal Assent, so that the definition "permanent establishment" in section 8201 of the Regulations will apply for the purpose of subparagraph 128.1(4)(*b*)(ii) of the Act.

Amended paragraph 128.1(4)(*b*) generally applies after October 1, 1996. In addition, an individual who ceased to be a Canadian resident after 1992 and before October 2, 1996 may also elect to exclude from the deemed disposition at emigration property described in the definition "excluded right or interest" in new subsection 128.1(10) of the Act. This election must be made in writing filed with the Minister of National Revenue within six months of these amendments receiving Royal Assent. It should also be noted that this election will cause amended subparagraph 115(1)(*a*)(i) of the Act to apply. For additional information, see the commentary on subsection 115(1).

### Individual – Elective Disposition, etc.

ITA
128.1(4)(*d*) and (*f*)

Paragraph 128.1(4)(*b*) treats taxpayers that cease to be resident in Canada as having disposed of their property, subject to certain exceptions, for proceeds equal to the property's fair market value. Paragraph 128.1(4)(*d*) allows an individual (other than a trust) to choose to treat certain of the properties that would otherwise be exempt from that deemed disposition as having been disposed of. An emigrant might make this choice if, for example, the emigrant wanted to realize a latent loss on such a property in order to offset a gain resulting from the deemed disposition.

This optional deemed disposition is retained in amended paragraph (*d*). In addition, the paragraph reproduces the effect of existing paragraph 128.1(4)(*f*), which ensures that losses realized as a result of a paragraph (*d*) election may only offset the increase, if any, in the taxpayer's income as a result of the deemed disposition on emigration. With this effect now provided in paragraph (*d*) itself, paragraph (*f*) is no longer necessary and is repealed.

These amendments apply to changes in residence after October 1, 1996.

### Employee CCPC Stock Option Shares

ITA
128.1(4)(*d*.1)

New paragraph 128.1(4)(*d*.1) is introduced to ensure appropriate tax consequences where an individual (other than a trust) emigrates from Canada holding shares that were acquired before February 28, 2000 under an employee stock option granted by a Canadian-controlled private corporation (CCPC). Taxation of the employment benefit associated with the acquisition of such a share is deferred, by subsection 7(1.1) of the Act, until such time as the individual disposes of the share. Similarly, the employment benefit is not added, under paragraph 53(1)(*j*) of the Act, to the adjusted cost base (ACB) of the share until disposition.

Although an individual holding such a share at the time of emigration is deemed, by paragraph 128.1(4)(*b*) to have disposed of the share at that time, new subsection 7(1.6) deems the disposition not to have occurred for the purposes of the stock option rules in section 7. Thus, while there is a disposition of the share for capital gains purposes, the fact that there is no disposition for purposes of the stock option rules means that the capital gain or loss would, were it not for paragraph 128.1(4)(*d*.1), be determined without the ACB being adjusted for the stock option benefit that is associated with the acquisition of the share and that will eventually be taxed under section 7. Because of changes to paragraph 53(1)(*j*), this is not an issue for shares acquired after February 27, 2000.

New paragraph 128.1(4)(*d*.1) addresses this by reducing the individual's proceeds of disposition in respect of the share by the amount of the stock option benefit that would have been added to the ACB of the share (by virtue of paragraph 53(1)(*j*)) had there been a deemed disposition of the share for the purposes of section 7. The application of paragraph 128.1(4)(*d*.1) is illustrated in the following example.

***Example***

*From 1993 to 1998, Katharine was employed by a CCPC. Part of Katharine's compensation for 1995 was an option to buy 100 shares of the corporation at a price of $1 a share. In 1996, when the shares were worth $2 each, Katharine exercised the option. In 2002, when the shares are worth $6 each, Katharine emigrates from Canada.*

*Under amended paragraph 128.1(4)(b), Katharine will be treated as having disposed of the shares for proceeds of $600 (= 100 x $6 fair market value). Ordinarily, the disposition would trigger an income inclusion of $100 under section 7 (= 100 x ($2 - $1)), a corresponding addition of $100 to the ACB of the shares under paragraph 53(1)(j) (resulting in a total ACB of $200), a deduction of $50 (= .5 x $100) under*

> *paragraph 110(1)(d.1) in computing taxable income, and a taxable capital gain of $200 (= .5 x ($600 - $200).*
>
> *However, as a result of new subsection 7(1.6), Katharine will not be subject to any income inclusion under section 7 in respect of the deemed disposition and, thus, there will be no addition to the ACB of the shares under paragraph 53(1)(j). Were it not for new paragraph 128.1(4)(d.1), this would result in Katharine having a taxable capital gain of $250 (= .5 ($600 - $100)) on the deemed disposition of the shares under paragraph 128.1(4)(b), and an additional income inclusion of $100 minus $50 on the actual disposition of the shares.*
>
> *Paragraph 128.1(4)(d.1) addresses this by deducting from the proceeds of disposition, for capital gains purposes, the $100 that paragraph 53(1)(j) would have added to the ACB of the shares if there had been an income inclusion under section 7 on emigration. As a result, Katharine will realize a taxable capital gain of $200 on the deemed disposition of the shares (and an additional income inclusion of $100 less $50 when she actually disposes of the shares).*

New paragraph 128.1(4)(*d*.1) applies to changes in residence after 1992.

**Deemed Property**

ITA
128.1(4)(*e*)

Existing paragraph 128.1(4)(*e*) relates to the election, under existing subparagraph (*b*)(iv), to exclude from the deemed disposition on emigration a property that is not taxable Canadian property. If an emigrant uses this optional exclusion, paragraph (*e*) treats the property as taxable Canadian property of the taxpayer until the property is disposed of or the taxpayer returns to Canada. Since the subparagraph (*b*)(iv) election is no longer available, paragraph (e) is repealed.

This amendment applies to changes in residence after October 1, 1996.

## Instalment Interest

ITA
128.1(5)

Sections 155 and 156 of the Act set out rules for computing the instalment obligations of individuals for a taxation year. Subsections 161(2), (4) and (4.01) of the Act set out rules for computing the interest payable by taxpayers on any deficiency in instalments made during a taxation year.

New subsection 128.1(5) of the Act provides a special rule for computing the instalment and instalment interest obligation of an individual for a taxation year in which the individual ceases to be a resident of Canada. This subsection applies to exclude, in computing an individual's liability for instalments for the year, the tax attributable to any deemed disposition under paragraph 128.1(4)(*b*), where that paragraph has the effect of increasing the individual's total tax payable under Parts I and I.1 of the Act for the year.

New subsection 128.1(5) applies to changes in residence that occur after October 1, 1996.

## Returning Former Resident

ITA
128.1(6)

New subsection 128.1(6) of the Act provides special rules that apply to an individual (other than a trust) who ceases to be resident in Canada at any time after October 1, 1996 (the "emigration time") and re-establishes Canadian residence at any particular time after that time. These rules allow the individual in effect to unwind the application of paragraphs 128.1(4)(*b*) and (*c*) to properties that were owned by the individual throughout the period beginning at the emigration time and ending at the particular time.

In broad terms, new subsection 128.1(6) means that an emigrant who returns to Canada at any time after emigration will no longer be treated as having realized accrued gains on departure. Four points should be noted about these rules. First, because there is no certain way of knowing which emigrants will return to Canada, this rule does not directly affect the obligations that arise on emigration. Rather, the rule does allow the returning individual retrospectively to modify the obligations. As a practical matter, it is expected that most individuals who plan to return to Canada will use the security provisions of subsection 220(4.5) to defer payment of any tax arising as a result of emigration. In that case, the main effect of new subsection 128.1(6) will be to allow the security to be given back intact to the returning emigrant.

Second, these rules do not affect any interest or penalties owing by an individual, including interest and penalties levied on taxes in respect of the individual's emigration, calculated without reference to the rule.

Third, these rules include features designed to prevent surplus-stripping. Without these features, a resident of Canada could use a temporary period of non-residence to extract, as dividends subject only to low-rate withholding tax, value that represents accrued gains.

Fourth, the rules require separate elections in respect of taxable Canadian property (paragraph (*a*)) and other property (paragraph (*c*)). The effects of the elections differ: the paragraph (*a*) election removes taxable Canadian properties from the deemed disposition and reacquisition on emigration, subject to special rules in paragraph (*b*); while the paragraph (*c*) election adjusts the emigration proceeds of disposition and the returning adjusted cost base of the other properties. Each election covers all property of the given sort, but the returning individual may choose to make one election and not the other.

Paragraph 128.1(6)(*a*) allows the individual to make an election in respect of property that was taxable Canadian property at the emigration time and throughout the period that the individual was non-resident. The effect of making this election is that paragraphs 128.1(4)(*b*) and (*c*) do not apply in respect of all such properties of the individual for the taxation year that includes the emigration time.

Where an individual has made an election under paragraph 128.1(6)(*a*), paragraph 128.1(6)(*b*) provides special surplus-stripping rules in respect of the property covered by the election. The basic purpose of paragraph (*b*) is to ensure that gains that accrued before emigration from Canada, and that have been extracted in the form of dividends during the individual's residence abroad, are subject to Canadian tax as gains.

Paragraph 128.1(6)(*b*) applies, in respect of a paragraph (*a*) taxable Canadian property, where two conditions are met:

- a loss has accrued on the property during the individual's period of non-residence – that is, the property's fair market value immediately before the individual becomes resident is less than its fair market value when the individual left Canada; and

- if the individual had acquired the property for its fair market value on emigration, and disposed of the property immediately before becoming resident, new subsection 40(3.7) (which applies to current and former non-resident individuals a version of the stop-loss rules in section 112 of the Act) would reduce the loss.

Where these conditions are met, paragraph (*b*) has four related effects. First, it treats the individual as having disposed of the property immediately before emigration, notwithstanding the paragraph (*a*) election. Second, it establishes the individual's proceeds of disposition of the property at that time, as the total of:

(A) the adjusted cost base of the property on emigration; and

(B) the amount, if any, by which the notional loss reduction under subsection 40(3.7) exceeds the lesser of (I) the adjusted cost base on emigration, and (II) an amount chosen by the individual.

Third, paragraph 128.1(6)(*b*) treats the individual as having reacquired the property on emigration, at a cost equal to the excess, if any, of the property's adjusted cost base on emigration (the (A) and (B)(I) amount above) over the lesser of the notional loss reduction under subsection 40(3.7) and the amount chosen by the individual in (B)(II) above.

The practical result of the second and third effects is that the income (in this case, dividends) that gives rise to the notional subsection 40(3.7) loss reduction is recharacterized as gains. Those gains are, subject to election, distributed between the post-return period and the deemed disposition on emigration.

Fourth, paragraph 128.1(6)(*b*) treats the individual, for the purposes of new section 119 of the Act, as having disposed of the property immediately before returning to Canada. This ensures that appropriate credit is given for any tax withheld under Part XIII of the Act on the income that triggered the application of paragraph 128.1(6)(*b*).

> ***Example** – 128.1(6)(b)*
>
> *Marie emigrates from Canada in 1999. Marie is the majority shareholder of a Canadian-controlled private corporation (CCPC) when she leaves Canada. The shares, which are taxable Canadian property to Marie, have a fair market value (FMV) at that time of $50,000 and an adjusted cost base (ACB) of $15,000, for a latent gain of $35,000. Marie receives $35,000 of dividends from the CCPC in 2000. In 2001, Marie returns to Canada. At that time, the shares have a FMV of $15,000. Marie uses the election in subsection 128.1(6) to minimize the tax consequences of her earlier emigration from Canada.*
>
> *If Marie actually disposed of the shares immediately before re-establishing Canadian residence, subsection 40(3.7) of the Act would reduce her loss. Therefore, paragraph 128.1(6)(b) applies in respect of the shares.*
>
> *Under paragraph 128.1(6)(b), Marie is treated as having disposed of and reacquired the shares on emigration. Assuming she elects $10,000, Marie's emigration proceeds of disposition are deemed to be $40,000, being the emigration ACB ($15,000) plus the difference between the subsection 40(3.7) reduction ($35,000) and the ACB/specified amount ($10,000). Marie thus realizes a $25,000 capital gain in the emigration year.*
>
> *Marie's reacquisition cost is deemed to be $5,000, being the original ACB ($15,000) minus the lesser of the subsection 40(3.7) reduction ($35,000) and the specified*

*amount ($10,000). Since the shares have a FMV of $15,000, Marie will eventually realize gain of $10,000 (subject to other adjustments to ACB and FMV).*

*The result is that Marie's $25,000 gain on departure and remaining $10,000 latent gain equal the $35,000 she extracted in the form of dividends. The full $35,000 will thus be realized as capital gains, and section 119 will give Marie credit for any withholding tax she paid on the dividends.*

*Marie could have altered the timing of her capital gains on the shares. For example, if she had elected an amount of $5,000 under paragraph (a) in respect of the property, Marie's emigration proceeds of disposition would have been $45,000 ($15,000 ACB + ($35,000 40(3.7) reduction - $5,000 elected amount)), giving an emigration gain of $30,000. This would have been balanced by an increase in Marie's reacquisition cost from $5,000 to $10,000, which in turn would reduce the eventual gain Marie will realize on the shares.*

New paragraph 128.1(6)(*c*) allows the returning individual to make an election, in respect of each property the individual owned at the emigration time and throughout the non-resident period that is subject to a deemed acquisition on immigration, under paragraph 128.1(1)(*c*) of the Act. In general, this describes property other than taxable Canadian property. The election adjusts, on a property-by-property basis, both the proceeds of disposition that were deemed to arise as a consequence of the deemed disposition in paragraph 128.1(4)(*b*) on the individual's earlier emigration, and the deemed acquisition cost under paragraph 128.1(1)(*c*).

Specifically, each of these amounts is adjusted by subtracting the least of:

- the amount that would otherwise be the individual's gain on the property as a result of the deemed disposition in paragraph 128.1(4)(*b*),
- the fair market value of the property immediately before the individual becomes resident in Canada, and
- any other amount specified by the individual.

As a result of these adjustments, the returning individual can generally defer Canadian tax on gains that had accrued before emigration, while still protecting from Canadian tax gains that accrued during periods of non-residence.

***Example** – 128.1(6)(c)*

*Noah emigrates from Canada in 1999. Noah owns shares of a foreign corporation. When Noah leaves, the shares have a fair market value of $25,000 and an adjusted cost base of $15,000, for an accrued gain of $10,000. In 2012, Noah returns to Canada. At that time the shares have a fair market value of $80,000. Noah chooses to take advantage of the election in paragraph 128.1(6)(c) to control the tax consequences of ceasing to be a Canadian resident. Because he had a capital loss in 1999 of $7,000 from another source, Noah is content to realize a $7,000 capital gain on emigration, but he does not want to realize the other $3,000 accrued gain. Noah therefore chooses an elected amount of $3,000.*

*Noah's proceeds of disposition under paragraph 128.1(4)(b) are deemed to be $22,000, being the proceeds of disposition that would otherwise be determined under paragraph 128.1(4)(b) ($25,000) minus the least of:*

- *the amount that would have been Noah's gain on the shares under 128.1(4)(b) had this paragraph not applied ($10,000);*
- *the fair market value of the property at the particular time ($80,000); and*
- *the elected amount specified ($3,000).*

*Noah thus reduces his emigration-year gain to $7,000. The same $3,000 that reduces Noah's emigration proceeds is also subtracted from his reacquisition cost under paragraph 128.1(1)(c) ($80,000), leaving his new adjusted cost base in respect of the property $77,000. The property thus has a latent gain of $3,000 at the time Noah re-establishes Canadian residence in 2012.*

> *Noah could have deferred tax on the full $10,000 gain that accrued before emigration, by increasing his elected amount in respect of the shares to $10,000.*

New subsection 128.1(6) applies to changes in residence that occur after October 1, 1996. The subsection provides that, notwithstanding the Act's ordinary rules governing assessments, any necessary assessments of tax will be made in order to take account of the effect of this new subsection.

A special transitional rule accommodates individuals who cease to be resident in Canada after October 1, 1996 and before these amendments receive Royal Assent, and who wish to make elections under new subsection 128.1(6). The elections for these transition period emigrants will be considered to have been made in a timely manner if they are made on or before the individual's filing-due date for the taxation year that includes the day on which Royal Assent is received.

In addition, the *Income Tax Regulations* will be amended to ensure that the Minister of National Revenue has discretion under the "fairness package" to allow elections under new subsection 128.1(6) to be late-filed. For additional information, see the commentary in Appendix B.

**Returning Trust Beneficiary**

ITA
128.1(7)

New subsection 128.1(7) of the Act provides special rules, which parallel new subsection 128.1(6) of the Act, applicable to an individual trust beneficiary (other than one that is itself a trust) who emigrates from Canada, receives distributions of trust property as a non-resident, and then re-establishes residence in Canada while still owning the property. In general terms, these rules allow the beneficiary and the trust to jointly elect, upon the beneficiary's return to Canada, to unwind the tax consequences to the trust that occurred when it distributed the property to the non-resident beneficiary.

A number of conditions must be met for the application of these rules: the individual must have been a resident of Canada and then ceased to be resident in Canada after October 1, 1996; the individual must have been a beneficiary of the trust at the time he or she ceased to be resident in Canada; the distribution must occur after October 1, 1996 and before the individual re-establishes residence in Canada; the distribution must be such that subsection 107(2) of the Act would have applied but for subsection 107(5); and the individual must re-establish residence in Canada after October 1, 1996 while still owning the property distributed by the trust.

Where these conditions are met, paragraph (*d*) provides an election for taxable Canadian property similar to the election provided in paragraph 128.1(6)(*a*). Paragraphs (*e*) and (*f*) provide anti-stripping rules similar to those provided by paragraph 128.1(6)(*b*). Paragraph (*g*) provides an election for property other than taxable Canadian property, similar to the election provided in paragraph 128.1(6)(*c*).

Paragraph (*h*) provides a special rule applicable if the trust ceases to exist before the individual's filing-due date for his or her taxation year during which he or she re-establishes residence in Canada. In such cases, the elections or specifications provided in new subsection 128.1(7) can be made by the individual alone. However, the individual and the trust will then be jointly and severally liable for any amount payable under the Act by the trust as a result of the election or specification.

Paragraph (*i*) allows any assessment of tax to be made that is necessary for the elections under new subsection 128.1(7) to be taken into account, but provides that no such assessment shall affect the computation of interest or penalties payable.

New subsection 128.1(7) applies to changes in residence that occur after October 1, 1996. A special transitional rule accommodates individuals who cease to be resident in Canada after October 1, 1996 and before these amendments receive Royal Assent, and who wish to make elections under new subsection 128.1(7). The elections for these transition period emigrants will be considered to have been made in a timely manner if they are made on or before the individual's filing-due date for the taxation year that includes the day on which Royal Assent is received.

In addition, it is proposed that the *Income Tax Regulations* be amended to ensure that the Minister of National Revenue has discretion under the "fairness package" to allow elections under new subsection 128.1(7) to be late-filed. For additional information, see the commentary in Appendix B.

**Post-Emigration Loss**

ITA
128.1(8)

New subsection 128.1(8) of the Act provides relief to an individual (other than a trust) who disposes of a taxable Canadian property, after having emigrated from Canada, for proceeds that are less than the deemed proceeds that arose under paragraph 128.1(4)(*b*) in respect of the property when the individual emigrated.

Under subsection 128.1(8) the individual may elect to reduce the proceeds of disposition that were deemed to arise under paragraph 128.1(4)(*b*) in respect of a property by the least of:

- an amount specified by the individual;
- the amount that would be the individual's gain from the deemed disposition of the property under paragraph 128.1(4)(*b*), but for this subsection; and
- the amount that would be the individual's loss from the disposition of the property at the time the property is actually disposed of, if the loss were determined with reference to every other provision in the Act (including the stop-loss rules in subsection 40(3.7) and section 112 of the Act) but this subsection.

The same amount is added to the individual's proceeds of disposition realized at the time of actual disposition.

***Example** – 128.1(8)*

*Odile emigrates from Canada in 1999, owning a capital interest in a trust resident in Canada that she purchased in 1997. The interest has a fair market value at the emigration time of $150,000 and an adjusted cost base of $40,000, for a latent gain of $110,000 on departure. Odile's tax is assessed on that basis, and she posts security for the tax.*

*In 2001, Odile sells her trust interest for $60,000. Since Odile has realized a smaller gain than assumed in her tax assessment on emigration, she elects under subsection 128.1(8) to reduce the gain she was deemed to have realized when she emigrated.*

*To obtain the maximum benefit from the subsection, Odile specifies an amount of $90,000 in respect of the election. Her proceeds of disposition at the emigration time are deemed to be $60,000, being the proceeds of disposition that would otherwise be determined under paragraph 128.1(4)(b) ($150,000) minus the least of:*

- *the amount specified ($90,000);*
- *the amount that would have been her taxable gain in respect of the trust interest under 128.1(4)(b) had this paragraph not applied ($110,000); and*
- *the amount that would have been her loss on actual disposition of the trust interest had this paragraph not applied ($150,000 - $60,000 = $90,000).*

*The same $90,000 amount is added to Odile's proceeds of the actual disposition of the trust interest. The result is that, in respect of the trust interest, Odile is treated as having realized a $20,000 gain in 1999, and no gain or loss on the actual disposition of the property in 2001.*

It should be noted that the election in subsection 128.1(8) does not affect any interest or penalties owing by the individual at the time of making the election, including interest and penalties levied on taxes in respect of the property, calculated without reference to the subsection.

A consequential amendment to subsection 152(6) of the Act ensures that any necessary assessments of tax will be made in order to take account of the effect of new subsection 128.1(8).

New subsection 128.1(8) applies to changes in residence that occur after October 1, 1996. A special transitional rule accommodates individuals who cease to be resident in Canada after October 1, 1996 and before these amendments receive Royal Assent, and who wish to make the election under new subsection 128.1(8). The election for these transition period emigrants will be considered to have been made in a timely manner if it is made on or before the individual's filing-due date for the taxation year that includes the day on which Royal Assent is received.

In addition, the *Income Tax Regulations* will be amended to ensure that the Minister of National Revenue has discretion under the "fairness package" to allow an election under new subsection 128.1(8) to be late-filed.

## Information Reporting

ITA
128.1(9)

New subsection 128.1(9) of the Act requires an individual who ceases to be resident in Canada after 1995 to file with the Minister of National Revenue, in prescribed form, a list of all the reportable properties that the individual owned at emigration time. This reporting requirement does not apply where the total fair market value of the individual's reportable properties at emigration time is $25,000 or less. However, where an individual owns reportable properties at emigration time with a total fair market value greater than $25,000, the individual must disclose all reportable properties on the information reporting form.

The term "reportable property" is defined in new subsection 128.1(10). For additional information, see the commentary on that subsection.

New subsection 128.1(9) applies to changes in residence that occur after 1995. The information reporting form must be filed on or before the individual's filing-due date for the year of emigration from Canada. However, a special transitional rule accommodates individuals who cease to be resident in Canada after 1995 and before these amendments receive Royal Assent – a form filed by these transition period emigrants will be considered to have been filed in a timely manner if it is filed on or before the individual's filing-due date for the taxation year that includes the day on which Royal Assent for these amendments is received.

**Definitions**

ITA
128.1(10)

New subsection 128.1(10) of the Act contains two new definitions that are used in section 128.1: "excluded right or interest" and "reportable property".

"excluded right or interest"

In general terms, an individual's excluded rights or interests include rights of the individual to future benefits or other payments under certain plans or arrangements, many of which are employer-sponsored or legislated in nature. It also includes interests of the individual in certain trusts and insurance contracts. The definition "excluded right or interest" is relevant for three main purposes.

First, the definition is relevant for paragraphs 128.1(1)(*b*) and (4)(*b*) of the Act, which treat individuals as having disposed of (and to have immediately reacquired) most of their property on immigrating to or emigrating from Canada. With one exception that applies with regard to individuals immigrating to Canada (see subparagraph 128.1(1)(*b*)(iv) for more details), excluded rights or interests are exempted from these deemed disposition rules.

Second, the definition is relevant for subclause 124(1) of the amending Notice of Ways and Means Motion, which allows individuals who emigrated from Canada after 1992 but before October 2, 1996 to elect to have their excluded rights or interests exempted from the deemed disposition rules at departure. For additional information, see the commentary on clause 124.

Third, the definition is relevant for the purpose of the information reporting requirement under new subsection 128.1(9) of the Act, which exempts from the reporting requirement certain properties that fall within the definition "excluded right or interest".

Paragraph (*a*) of the definition "excluded right or interest" refers to rights of the individual under, or an interest of the individual in a trust governed by, certain plans. The plans referred to in this paragraph include pension plans (including registered pension plans), retirement compensation arrangements, registered retirement savings plans, registered retirement income funds and foreign retirement arrangements (defined in section 6803 of the *Income Tax Regulations* to mean certain Individual Retirement Accounts established under the United States *Internal Revenue Code*). Also included are deferred profit sharing plans, employee profit sharing plans, employee benefit plans (EBPs) (other than those described in paragraph (*b*) of this definition) and plans under which the individual has a right to receive remuneration for services rendered in the year or a previous year (including, for example, salary deferral arrangements (SDAs), unfunded bonus deferrals, self-funded leaves of absence and phantom stock plans). Registered supplementary unemployment benefit plans and registered education savings plans are also included in this paragraph.

Paragraph (*b*) of the definition refers to rights of the individual to a benefit under an EBP that would be an SDA if it were not specifically exempted from being an SDA by virtue of paragraphs (*j*) and (*k*) of the definition of "salary deferral arrangement" in subsection 248(1) of the Act or by virtue of paragraph 6801(*c*) of the Regulations. (The former exemption is for deferred salary arrangements for professional athletes, the latter for deferred salary arrangements for National Hockey League on-ice officials.) Only the right that relates to the portion of the benefit that is attributable to services rendered by the individual in Canada is included in "excluded right or interest".

Paragraph (*c*) of the definition refers to rights of the individual under an agreement referred to in subsection 7(1) of the Act. That subsection refers to agreements under which employees of a corporation or of a mutual fund trust are granted certain rights to acquire shares of the corporation (or a related corporation) or units of the trust.

Paragraph (*d*) of the definition refers to rights of the individual to a retiring allowance.

Paragraph (*e*) of the definition refers to rights of the individual under, or an interest of the individual in, an employee trust, an amateur athlete trust, a cemetery care trust or a trust governed by an eligible funeral arrangement.

Paragraph (*f*) of the definition refers to rights of the individual to receive payments under an annuity contract or an income-averaging annuity contract.

Paragraph (*g*) of the definition refers to rights of the individual to benefits under the *Canada Pension Plan*, the *Québec Pension Plan*, the *Old Age Security Act* and the *Saskatchewan Pension Plan*. It also refers to rights of the individual to benefits under foreign social security arrangements.

Paragraph (*h*) of the definition refers to rights of the individual to benefits referred to in subparagraphs 56(1)(*a*)(iii) to (vi) of the Act. Those subparagraphs refer to death benefits, certain employment insurance benefits, certain benefits provided in connection with the Canada-United States Agreement on Automotive Products and prescribed benefits received under government assistance programs.

Paragraph (*i*) of the definition refers to a right of the individual to a payment out of a NISA ("net income stabilization account") Fund No. 2 under the *Farm Income Protection Act*.

Paragraph (*j*) of the definition refers to an interest of the individual in a personal trust resident in Canada, provided the interest was never acquired (by any person) for consideration and did not arise as a consequence of a transfer by the individual that would be a "qualifying disposition" under subsection 107.4(1) if that subsection were read without reference to paragraphs 107.4(1)(*h*) and (*i*). See further in this regard, the commentary on new subsections 107.4(1), 108(6) and 108(7) and new paragraph 107.4(3)(*h*). Each of these provisions is relevant for the purposes of determining the scope of paragraph (*j*).

Paragraph (*k*) of the definition refers to an interest of the individual in a non-resident testamentary trust, provided the interest was never acquired (by any person) for consideration.

Paragraph (*l*) of the definition refers to an interest of the individual in a life insurance policy in Canada (except for that part of the policy in respect of which the individual is deemed by paragraph 138.1(1)(*e*) of the Act to have an interest in a related segregated fund trust).

"reportable property"

The definition "reportable property" is relevant for the purpose of the information reporting requirement, for individuals who emigrate from Canada, under new subsection 128.1(9) of the Act.

"Reportable property" means any property of the individual other than the following:

(a) money that is legal tender in Canada and deposits of such money;

(b) property falling within the definition "excluded right or interest" in new subsection 128.1(10) of the Act, except for employee options in shares of corporations or in units of mutual fund trusts, certain interests in personal trusts resident in Canada, and interests in a life insurance policy in Canada;

(c) for individuals (other than trusts) who were resident in Canada for 60 months or less in the 120-month period that precedes the time of emigration, property, other than taxable Canadian property, that was owned by the individual before the individual became resident in Canada or that was acquired by the individual by inheritance or bequest after becoming resident in Canada; and

(d) any item of personal-use property the fair market value of which at emigration time is less than $10,000.

## Clause 124

## Transition

Paragraph 128.1(4)(*b*) of the Act treats a person who ceases to be resident in Canada as having disposed of most of the person's properties. The changes these amendments introduce to that deemed disposition apply, as a general matter, after October 1, 1996. However, certain of the changes are relieving clarifications of the scope of the deemed disposition. This provision allows a taxpayer who ceased to be resident in Canada after 1992 and before October 2, 1996 to elect that those relieving changes apply to that cessation of residence. In particular, an election under this provision will allow an individual who ceased to be resident in Canada after 1992 and before October 2, 1996 to rely on the new definition "excluded right or interest" in new subsection 128.1(10) of the Act in respect of that cessation of residence, for the purpose of the deemed disposition rules under subsection 128.1(4) of the Act.

It should be noted that such an election, which must be made in writing filed with the Minister of National Revenue before the end of the sixth month following Royal Assent to these amendments, will also cause certain changes to section 115 of the Act to apply. For additional information, see the commentary on section 115 and subsection 128.1(4).

## Clause 125

### Former Resident – Replaced Shares

ITA
128.3

New section 128.3 of the Act applies to shares ("old shares") that were received in exchange for other shares ("new shares") on a tax-deferred basis pursuant to section 51 (convertible property), subparagraphs 85.1(1)(*a*)(i) or (ii) (transfer of property to a corporation by shareholders), section 86 (exchange of shares by a shareholder in the course of a reorganization of a company's capital) or section 87 (amalgamation) of the Act. For the purposes of section 119 and subsections 126(2.21) to (2.23), 128.1(6) to (8), 180.1(1.4) and 220(4.5) and (4.6) of the Act, the individual is deemed not to have disposed of the old shares, and the new shares are deemed to be the old shares. This ensures that the relief available under those provisions is not lost as a result of such a share-for-share exchange.

New section 128.3 applies after October 1, 1996.

## Clause 126

### Private Corporations

ITA
129(3.1)

New subsection 129(3.1) revives a transitional rule previously contained in subsection 129(3.2). That transitional rule allowed a private corporation, other than a Canadian-controlled private corporation (CCPC), to include in its refundable dividend tax on hand (RDTOH) for taxation years commencing after November 12, 1981 certain income in respect of property disposed of by it before November 13, 1981. The rule was intended to allow certain private corporations that were not CCPCs to benefit for a transitional period from some aspects of the RDTOH scheme that became, after 1981, limited only to CCPCs.

The RDTOH computation rules were subsequently simplified for taxation years ending after June 1995. As part of this simplification process, subsection 129(3.2) was repealed on the assumption that it had fulfilled its transitional function. It has since been determined that, despite the passage of almost 14 years since the transitional provision was enacted, at least one taxpayer was still using subsection 129(3.2) in 1995. The rule is therefore being revived for taxation years ending after June 1995 and before 2003, in order to give adequate opportunity for this and any other taxpayers who may be relying on the rule to adjust to the 1981 RDTOH provisions.

New subsection 129(3.1) applies to taxation years that end after June 1995 and before 2003.

## Clause 127

### Mortgage Investment Corporations

ITA
130.1

Section 130.1 of the Act sets out rules that apply to mortgage investment corporations and their shareholders. A mortgage investment corporation is essentially treated as a conduit in that its income may be flowed through to its shareholders and taxed in their hands rather than in the corporation.

## Deduction from Tax

ITA
130.1(1)(*a*)(ii)

Subsection 130.1(1) of the Act provides rules for calculating the income of a mortgage investment corporation for a taxation year. The amendment to subparagraph 130.1(1)(*a*)(ii) replaces the reference to the fraction "3/4" with a reference to the fraction "1/2", consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a mortgage investment corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "1/2" is to be read as reference to the fraction in amended paragraph 38(*a*) of the Act that applies to the corporation for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Election re Capital Gains Dividend

ITA
130.1(4)

Where a mortgage investment corporation elects in respect of the full amount of a dividend, subsection 130.1(4) of the Act deems the dividend to be a capital gains dividend to the extent that it does not exceed 4/3 of the undistributed taxed capital gains of the corporation for the year, and the dividend is deemed to be a capital gain of the dividend recipient from the disposition of property in the year in which the dividend was received.

The amendment to subparagraph 130.1(4)(*a*)(i) replaces the reference to the expression "4/3 of" with a reference to the word "twice". The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a mortgage investment corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference the word "twice" in subparagraph 130.1(4)(*a*)(i) is to be read as reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the corporation for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

The amendment to paragraph 130.1(4)(*b*), which is applicable for taxation years that end after February 27, 2000, is consequential to the change to the inclusion rate for capital gains. The amendment ensures that the inclusion rate for capital gains realized on property disposed of before February 28, 2000, or after February 27, 2000 and before October 18, 2000, is 3/4 and 2/3, respectively.

Where the taxation year of the dividend recipient began after February 27, 2000 and ended before October 18, 2000 and the capital gains dividend was paid out of capital gains from property disposed of before February 27, 2000, 9/8 of the dividend is deemed by subparagraph 130.1(4)(*b*)(i) to be a capital gain from the disposition of property in the recipient's taxation year.

Where the taxation year of the dividend recipient began before and ended after February 27, 2000 and the capital gains dividend was paid out of capital gains from property disposed of before February 27, 2000, the dividend is deemed by subparagraph 130.1(4)(*b*)(ii) to be a capital gain of the recipient from the disposition of a capital property before February 27, 2000.

Where the taxation year of the dividend recipient began after October 17, 2000, and the capital gains dividend was paid out of capital gains from property disposed of before February 28, 2000, 3/2 of the dividend is deemed by subparagraph 130.1(4)(*b*)(iii) to be a capital gain of the recipient from the disposition of a capital property in the recipient's taxation year.

Where the taxation year of the dividend recipient began after October 17, 2000 and the capital gains dividend was paid out of capital gains from property disposed of after February 27, 2000 and before October 18, 2000, 4/3 of the dividend is deemed by subparagraph 130.1(4)(*b*)(iv) to be a capital gain of the recipient from the disposition of a capital property in the recipient's taxation year.

Where the taxation year of the dividend recipient includes October 17, 2000 and the capital gains dividend was paid out of capital gains from property disposed of after February 27, 2000 and before October 18, 2000, the dividend is deemed by subparagraph 130.1(4)(*b*)(v) to be a capital gain of the recipient from the disposition of a capital property in the year and before October 18, 2000 and after February 27, 2000.

Where the taxation year of the dividend recipient began after February 27, 2000 and ended before October 18, 2000 and the capital gains dividend was paid out of capital gains from property disposed of after February 27, 2000 and before October 18, 2000, the dividend is deemed by subparagraph 130.1(4)(*b*)(vi) to be a capital gain from the disposition of a capital property in the recipient's taxation year.

In any other case, under subparagraph 30.1(4)(*b*)(vii) the dividend is deemed to be a capital gain of the recipient from the disposition of a capital property after October 17, 2000 and in the year the dividend was received.

This amendment applies to taxation years that end after February 27, 2000.

## Capital Gains Dividend – Reporting and Allocation

ITA
130.1(4.2) to (4.5)

Subsection 130.1(4) of the Act applies where a dividend is payable by a mortgage investment corporation and the corporation elects to have the dividend treated as a capital gains dividend. Where that subsection applies in respect of a dividend paid in the period that begins 91 days after the beginning of the corporation's taxation year that includes either February 28, 2000 or October 17, 2000 and ends 90 days after the end of that year by a mortgage investment corporation to a shareholder of any class of shares of its capital stock, new subsection 130.1(4.2) requires the corporation to disclose to the shareholder in prescribed form the amount of the dividend that can reasonably be considered to have been paid out of its capital gains realized on dispositions by the corporation of property in each of the following three periods in the year:

- before February 28, 2000;
- after February 27, 2000 and before October 18, 2000; and
- after October 17, 2000.

If it does not do so, the dividend is deemed to be in respect of capital gains realized on dispositions of property that occurred before February 27, 2000.

New subsection 130.1(4.3) of the Act applies where the corporation does not elect under subsection 130.1(4.4) to treat its capital gains to be realized evenly over the year.

When the election under subsection 130.1(4.4) is not made:

- The portion of the dividend that is in respect of capital gains realized by the mortgage investment corporation in respect of dispositions of property that occurred in the year and in a particular period that begins at the beginning of the year and ends at the end of February 27, 2000 is deemed to be that proportion of the dividend that the corporation's net capital gains from dispositions of property in the particular period is of the total of the corporation's net capital gains from dispositions of property in each of the particular periods referred to in that subsection.
- The portion of the dividend that is in respect of capital gains realized by the mortgage investment corporation in respect of dispositions of property that occurred in the year and in the particular period that began at the beginning of February 28, 2000 and ended at the end of October 17, 2000 is deemed to be that proportion of the dividend that the corporation's net capital gains from dispositions of property in the particular period is of the total of the corporation's net capital gains dispositions of property in each of the particular periods referred to in this subsection.
- The portion of the dividend that is in respect of capital gains realized by the mortgage investment corporation in respect of

> dispositions of property that occurred in the year and in the particular period that begins at the beginning of October 18, 2000 and ends at the end of the year, is deemed to be that proportion of the dividend that the corporation's net capital gains from dispositions of property in the particular period is of the total of the corporation's net capital gains from dispositions of property in each of the particular periods referred to in this subsection.

For the purposes of this new subsection, net capital gains of a mortgage investment corporation from dispositions of property in a period means the amount, in any, by which the corporation's capital gains from dispositions of property in the period exceeds the corporation's capital losses from dispositions of property in the same period.

New subsection 130.1(4.4) provides that a mortgage investment corporation can elect, for its taxation year that includes either February 28, 2000 or October 17, 2000, to apportion its capital gains dividends for the year amongst the three periods in the year described above.

The portion for each period is determined to be that proportion of the dividend that the number of days that are in the year and in that period is of the number of days in the year. New subsection 130.1(4.5) of the Act provides a special rule that applies where no dividend to which subsection 130.1(4.4) applies is paid by a mortgage investment corporation in respect of its net taxable capital gains for its taxation year that includes either February 28, 2000 or October 17, 2000.

Where the corporation elects, it can treat its net capital gains or net capital losses as having been realized equally over the number of days in its taxation year, so that the net capital gains and losses in each of the periods will equal that proportion of the net capital gains and losses that the number of days in the year of the corporation that are in each period is of the number of days in the year. This election will permit a mortgage investment corporation to treat its net capital gains and losses as having been realized equally throughout the year for the purpose of calculating its capital gains inclusion rate for the year.

For the purpose of this new subsection, net capital gains of a mortgage investment corporation is defined as the amount, if any, by which the corporation's capital gains from dispositions of property in a taxation year exceeds the corporation's capital losses from dispositions of property in the year, and net capital losses of a mortgage investment corporation is defined as the amount, if any, by which the corporation's capital losses from dispositions of property in a taxation year exceeds the corporation's capital gains from dispositions of property in the year.

New subsections 130.1(4.2) to (4.5) apply to taxation years that end after February 27, 2000.

## Clause 128

## Mutual Fund Corporations

ITA
131

Section 131 of the Act sets out rules relating to the taxation of mutual fund corporations and their shareholders.

### Election re Capital Gains Dividend

ITA
131(1)(*b*)

Where a mutual fund corporation elects in respect of the full amount of a dividend, the dividend, to the extent that it does not exceed the corporation's capital gains dividend account, is deemed to be a capital gains dividend and the dividend recipient is deemed to have a capital gain for the taxation year in which the dividend is received from the disposition of property in the year.

The amendment to paragraph 131(1)(*b*) of the Act, which is applicable for taxation years that end after February 27, 2000, is consequential to the change to the inclusion rate for capital gains. The amendment ensures that the inclusion rate for capital gains realised on property disposed of before February 27, 2000 is 3/4.

Where the taxation year of the dividend recipient began after February 27, 2000 and ended before October 18, 2000 and the capital gains dividend was paid out of capital gains from property disposed of by the mutual fund corporation before February 27, 2000, 9/8 of the dividend is deemed by subparagraph 131(1)(*b*)(i) to be a capital gain of the recipient from the disposition of a capital property in the year in which the dividend is received.

Where the taxation year of the dividend recipient began before and ended after February 27, 2000 and the capital gains dividend was paid out of capital gains from property disposed of by the mutual fund corporation before February 27, 2000, the dividend is deemed by subparagraph 131(1)(*b*)(ii) to be a capital gain of the recipient from the disposition of a capital property before February 27, 2000.

Where the taxation year of the dividend recipient began after October 17, 2000 and the capital gains dividend was paid out of capital gains from property disposed of by the mutual fund corporation before February 28, 2000, 3/2 of the dividend is deemed by subparagraph 131(1)(*b*)(iii) to be a capital gain of the recipient from property in the year.

Where the taxation year of the dividend recipient began after October 17, 2000 and the capital gains dividend was paid out of capital gains from property disposed of by the mutual fund corporation after February 27, 2000 and before October 18, 2000, 4/3 of the dividend is deemed by subparagraph 131(1)(b)(iv) to be a capital gain of the recipient from property disposed in the year.

Where the taxation year of the dividend recipient includes October 17, 2000 and the capital gains dividend was paid out of capital gains from property disposed of by a mutual fund corporation after February 27, 2000 and before October 18, 2000, the dividend is deemed by subparagraph 131(1)(*b*)(v) to be a capital gain of the recipient from the disposition of a capital property in the year and before October 18, 2000 and after February 27, 2000.

Where the taxation year of the dividend recipient began after February 27, 2000 and ended before October 18, 2000 and the capital gains dividend was paid out of capital gains from property disposed of by the mutual fund corporation after February 27, 2000 and before October 18, 2000, the dividend is deemed by subparagraph

131(1)(*b*)(vi) to be a capital gain of the recipient from the disposition of a capital property in the year.

In any other case, the dividend is deemed by subparagraph 131(1)(*b*)(vii) to be a capital of the taxpayer from the disposition of a capital property after October 17, 2000 and in the year in which the dividend was received.

Dividends paid by a corporation are deemed to be paid in respect of the corporation's net capital gains in the order in which those net capital gains were realized by the corporation.

For that purpose,

- A corporation's net capital gains for a year is the amount by which the corporation's capital gains from dispositions of property in the year exceed the corporation's capital losses from dispositions of property in the year.
- A corporation's net capital losses for a year is the amount by which the corporation's capital losses from dispositions of property in the year exceed the corporation's capital gains from dispositions of property in the year.
- Net capital gains of a corporation for a year are deemed to be realized evenly throughout the year.
- Net capital losses of a corporation for a year are deemed to be a capital loss of the corporation from the disposition of property in the following year.

## Capital Gains Dividend

ITA
131(1.5) to (1.9)

Section 131(1) of the Act applies where a dividend is payable by a mutual fund corporation and the corporation elects that the dividend be treated as a capital gains dividend.

Section 131(1) is amended to add new subsections 131(1.5) to (1.9), applicable for taxation years that end after February 27, 2000.

Where a capital gains dividend is paid by a mutual fund corporation to a shareholder of any class of shares of its capital stock, new subsection 131(1.5) provides that the corporation must disclose to the shareholder in prescribed form the amount of the dividend that can reasonably be considered to have been paid out of its capital gains realized on dispositions by the corporation of property before February 28, 2000, after February 27, 2000 and before October 18, 2000, and after October 17, 2000. If it does not do so, the dividend is deemed to be in respect of capital gains realized on dispositions of property that occurred before February 28, 2000.

New subsection 131(1.6) of the Act applies where the corporation does not elect under subsection 131(1.7) to treat its capital gains to be realized evenly over the corporation's taxation year that includes either February 28, 2000 or October 17, 2000.

When the election is not made:

- The portion of the dividend that is in respect of capital gains realized by the mutual fund corporation in respect of dispositions of property that occurred in the year and before February 28, 2000 is deemed to be that proportion of the dividend that the capital gains of the corporation from dispositions of property before February 28, 2000 to which the dividend relates is of the corporation's net capital gains for the year.

- The portion of the dividend that is in respect of capital gains realized by the mutual fund corporation in respect of dispositions of property that occurred in the year and in the particular period that began at the beginning of February 28, 2000 and ended at the end of October 17, 2000 is deemed to be that proportion of the dividend that the net capital gains of the corporation from dispositions of property in the year and in the particular period is of the corporation's capital gains for the year.

- The portion of the dividend that is in respect of capital gains realized by the mutual fund corporation in respect of dispositions of property that occurred in the year and in the particular period that begins at the beginning of October 18, 2000 and ends at the end of the year, is deemed to be that proportion of the dividend that the net capital gains of the corporation from dispositions of property in the year and in the particular period is of the corporation's capital gains for the year.

For the purposes of this new subsection, the net capital gains of a corporation for a period is the amount, in any, by which the corporation's capital gains from dispositions of property in the period exceeds the corporation's capital losses from dispositions of property in the same period.

New subsection 131(1.7) of the Act provides that a mutual fund corporation can elect, for its taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, to treat a portion of its capital gains dividends for the year to be in respect of capital gains realized on dispositions of property

- before February 28, 2000,
- in the period that begins at the beginning of February 28, 2000 and ends at the end of October 17, 2000, and
- in the period that begins at the beginning of October 18, 2000 and ends at the end of the year.

The portion is determined as that proportion of the dividend that the number of days that are in the year and in that period is of the number of days in the year.

New subsection 131(1.8) of the Act applies where the total amount of dividends paid under subsections 131(1.6) and (1.7) by a mutual fund corporation in the period that begins 60 days after the beginning of the corporation's taxation year that includes either February 28, 2000 or October 17, 2000 and ends 60 days after the end of the corporation's taxation year and to which subsection 131(1) applies exceeds the total amount of the corporation's net capital gains from dispositions of property in that year.

In that case the amount of those dividends to which subsections 131(1.6) and (1.7) apply is the amount of the corporation's net capital gains from dispositions of property in that year, and the amount, if any, by which total amount of the dividends paid by the corporation in the period exceeds the total amount of the corporation's net capital gains from dispositions of property in that year is deemed to be a dividend in respect of capital gains from dispositions of property in the first of the periods.

New subsection 131(1.9) of the Act provides a special rule that applies where no dividend to which subsection 131(1.7) applies is paid by a mutual fund corporation in respect of its net taxable capital gains for its taxation year that includes either February 28, 2000 or October 17, 2000.

Where the corporation elects, it can treat its net capital gains or net capital losses as having been realized equally over the number of days in its taxation year, so that the net capital gains and losses in each of the periods will equal that proportion of the net capital gains and losses that the number of days in the year of the corporation that are in each period is of the number of days in the year. This election will permit a mutual fund corporation to treat its net capital gains and losses as having been realized equally throughout the year for the purpose of calculating its capital gains inclusion rate for the year.

For the purpose of this new subsection, net capital gains of a mutual fund corporation is defined as the amount, if any, by which the corporation's capital gains from dispositions of property in the year exceeds the corporation's capital losses from dispositions of property in the year, and net capital losses of a mutual fund corporation is defined as the amount, if any, by which the corporation's capital losses from dispositions of property in the year exceeds the corporation's capital gains from dispositions of property in the year.

### Capital Gains Refund to Mutual Fund Corporation

ITA
131(2)(*a*)

A mutual fund corporation is entitled to a capital gains refund for a taxation year equal to the lesser of 21% of the total of its capital gains dividends paid for the year, its capital gains redemptions for the year and the amount of its refundable capital gains tax on hand at the end of the year.

Generally, the refundable capital gains tax on hand of a mutual fund corporation is 28% of its taxed capital gains (or 21 % of its capital gains for the year where the relevant inclusion rate for capital gains is 3/4). The refundable capital gains tax on hand could be less then 21% of capital gains where the taxable income of the mutual fund corporation is less than its taxed capital gains.

The amendments to paragraph 131(2)(*a*) of the Act replace the reference to "21%" with the reference to "14%", and add that the Minister can determine another amount after giving consideration to the percentages applicable in determining the corporation's capital gains refund and refundable capital gains tax on hand for the year and preceding taxation years. These amendments are consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendments apply to taxation years that end after February 27, 2000 except that, for the taxation year of a mutual fund corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the percentage "14%" in subparagraph 131(2)(*a*)(i) is to be read as reference to the percentage determined when 28% is multiplied by the fraction in amended paragraph 38(*a*) of the Act that applies to the corporation for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Definitions

ITA
131(6)

"capital gains dividend account"

The "capital gains dividend account" of a mutual fund corporation represents the cumulative net undistributed capital gains of the corporation on which it paid refundable capital gains tax.

In determining its capital gains dividend account balance, a mutual fund corporation must deduct 100/21 of its capital gains refunds for the year, representing capital gains distributions in respect of which the corporation received capital gains refunds.

The amendment to subparagraph (*b*)(iii) of the definition "capital gains dividend account" is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2 for taxation years that end after February 27, 2000. With the inclusion rate reduction to 1/2 and using a 28% corporate tax rate, refundable tax and refunds approximate 14% of capital gains. For taxation years that ended before February 28, 2000, the rate remains unchanged at 21%.

The amendment applies to taxation years that end after February 27. 2000 except that, for the taxation year of a mutual fund corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the percentage "14%" in subsection 131(6)(*b*)(iii)(B) of the Act is to be read as reference to the fraction "100/28X", where "X" is the fraction in amended paragraph 38(*a*) of the Act that applies to the corporation for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

"capital gains redemptions"

The "capital gains redemptions" of a mutual fund corporation for a year are used in determining the mutual fund corporation's capital gains refund for the year. In calculating the capital gains redemptions, the corporation must allocate accrued capital gains and undistributed realized net capital gains across all payments on the redemptions of shares in the year.

The amendment to the description of C in the definition "capital gains redemptions" replaces the fraction "100/21" with the fraction "100/14", and is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for the taxation year of a mutual fund corporation that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the fraction "100/14" in the description of C in the definition "capital gains redemptions" in subsection 131(6) is to be read as reference to fraction "100/28X", where "X" is the fraction in amended paragraph 38(*a*) that applies to the corporation for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Mutual Fund Corporations

ITA
131(8.1)(*a*)

Subsection 131(8.1) of the Act provides that a corporation is not a mutual fund corporation after a particular time if, at that time, it is reasonable to conclude that the corporation was established or maintained primarily for the benefit of non-resident persons. Two conditions provide exceptions to this rule. The first of these conditions, which is set out in paragraph 131(8.1)(*a*), is met if, throughout the period that started on February 21, 1990 (or if later, the date of incorporation) and that ends at the particular time, all or substantially all of the corporation's property consisted of property other than Canadian real property, options therein and other taxable Canadian property.

Paragraph 131(8.1)(*a*) is replaced, with effect after October 1, 1996, with new wording that incorporates changes in the definition of "taxable Canadian property" and the relocation of that definition from paragraph 115(1)(*b*) of the Act to subsection 248(1) of the Act.

## Clause 129

## Mutual Fund Trusts

ITA
132

Section 132 provides for a refund to a mutual fund trust in respect of the tax which the fund has paid on its capital gains distributed to its beneficiaries through a redemption of units. This mechanism is to avoid double taxation.

## Capital Gains Refunds to Mutual Fund Trusts

ITA
132(1)(*a*)

A mutual fund trust is entitled to capital gains refund for a year equal to the lesser of 21.75% of its capital gains redemptions for the year and its refundable capital gains tax on hand at the end of the year.

The 21.75% rate is based a trust tax rate of 29% and a 3/4 inclusion rate for capital gains. The refund rate is changed to 14.5%, applicable to taxation years that end after February 27, 2000. The Minister of National Revenue will be able to determine a different refund after giving consideration to the percentages applicable in determining the trust's capital gains refund for the year and preceding taxation years and the percentage applicable in determining the trust's refundable capital gains tax on hand at the end of the year. Those changes are consequential to the decrease of the inclusion rate for capital gains from 3/4 to 1/2.

The amendments apply to taxation years that end after February 27, 2000 except that, for the taxation year of a mutual fund trust that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the percentage "14.5%" in subparagraph 132(1)(*a*)(i) of the Act is to be read as reference to the percentage determined when 29% is multiplied by the fraction in amended paragraph 38(*a*) of the Act that applies to the trust for the year. These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Definitions

ITA
132(4)

Subsection 132(4) of the Act defines two expressions for the purpose of section 132.

"capital gains redemptions"

The capital gains redemptions of a mutual fund trust for a year are used in determining the trust's capital gains refund for the year. In calculating the capital gains redemptions, the trust must allocate accrued capital gains and undistributed realized net capital gains across all payments on the redemptions of units in the year. The first amendment replaces the first formula in the definition "capital gains redemptions" in subsection 132(4) of the Act. The new formula provides for the deduction of an amount "E" in the calculation of the amount of the trust's capital gains redemptions. This amendment applies to taxation years that end after February 27, 2000.

The second amendment replaces the description of A in that definition. The amended description refers to the portion of payments on the redemption of units that are included in the proceeds of disposition in respect of the redeemed units. This amendment applies to taxation years that end after February 27, 2000.

The description of A in that definition is further amended to exclude from the amounts that may be included in A the portion of an amount that is an amount of proceeds determined under paragraph 107(2.1)(*c*) in respect of a redemption of units. This amendment applies to redemptions made after Announcement Date.

The third amendment replaces the fraction "100/21.75" with the fraction "100/14.5" in the description of C in that definition, and is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2. This amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a mutual fund trust that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the references to the fraction "100/14.5" in the description of C in the definition "capital gains redemptions" in subsection 132(4) are to be read as a reference to the fraction "100/29X", where "X" is the fraction in amended paragraph 38(*a*) of the Act that applies to the trust for the year.

The last amendment adds the description of E. This refers to twice the total of all amounts each of which is an amount designated by the trust under subsection 104(21) of the Act in respect of units redeemed by the trust in the year and after December 21, 2000. This amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a mutual fund trust that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" is to be read as a reference to the expression "the fraction that is the reciprocal of the fraction in paragraph 38(*a*) that applies to the taxpayer for the year, multiplied by". These modifications are required in order to reflect the capital gains/losses inclusion rate for the year.

## Retention of Status as Mutual Fund Trust

ITA
132(6.2)

New subsection 132(6.2) of the Act applies where a mutual fund trust ceases to exist. The taxation year of the mutual fund trust (determined with reference to paragraph 249(1)(*b*)) is not affected by its termination, unless paragraph 132.2(1)(*b*) applies. Consequently, the last taxation year of a mutual fund trust under the existing income tax rules is generally the calendar year in which it terminates. This leads to unintended consequences under a number of provisions of the Act (including the capital gains refund measure in subsection 132(1), the exemption from the alternative minimum tax in subparagraph 127.55(*f*)(ii) and the exemption from Part XII.2 tax in section 210.1) that require that a trust be a mutual fund trust throughout a taxation year.

New subsection 132(6.2) is intended to address these unintended consequences. A trust is deemed to be a mutual fund trust throughout a calendar year where:

- but for new subsection 132(6.2), at any time in the year the trust would have ceased to be a mutual fund trust because the trust ceased to exist or because of the non-application of paragraph 108(2)(*a*) (i.e., units cease to be redeemable) or the application of 132(6)(*c*) (i.e., 150 unitholder requirement no longer satisfied);

- the trust was a mutual fund trust at the beginning of the year; and

- the trust would, throughout the portion of the year throughout which it was in existence, have been a mutual fund trust if

    - where the condition in paragraph 108(2)(*a*) was satisfied at the beginning of the year, that condition were satisfied throughout the year, and

- paragraph 132(6)(*c*) and subsection 132(6.2) were not taken into account.

This amendment, which is similar to new subsection 250(6.1), applies to the 1990 and subsequent taxation years.

ITA
132(7)

Under subsection 132(7) of the Act, a trust does not qualify as a mutual fund trust in certain cases where it is reasonable to conclude that the trust was established primarily for the benefit of non-resident persons. The provision's purpose was to discourage the use of mutual fund trusts as intermediaries through which non-residents could invest in Canadian real estate and other taxable Canadian property without recognizing any gains on the disposition of units in trust. However, transitional relief was intended to be provided in the case of a trust that did not issue units after February 20, 1990 otherwise than as a capitalization of an income distribution.

Subsection 132(7) is amended to change references to Canadian real estate, and to specified other taxable Canadian property in section 115, to references to the same types of property in the new definition "taxable Canadian property" in subsection 248(1). This amendment applies after October 1, 1996.

Subsection 132(7) is also amended to ensure that the transitional relief operates as described above. The amendment also ensures that this transitional relief is not interrupted by reason only of an issue of units in satisfaction of payments made out of a trust's capital gains.

## Clause 130

## Mutual Fund Trusts – December 15 Year End

ITA
132.11

Section 132.11 of the Act generally allows a mutual fund trust to elect to have taxation years that end on December 15, rather than on December 31. Where the election is made, each subsequent taxation year of an electing trust is deemed under paragraph 132.11(1)(*b*) to start on December 16 of a calendar year and end on December 15 of the following calendar year (or at such earlier time as is determined under paragraph 132.2(1)(*b*) or under subsection 142.6(1)).

Subsection 132.11(4) is designed to permit distributions made in the last 16 days of a calendar year in respect of a trust's taxation year ending on December 15 of the calendar year to be treated as if they were made at the end of that taxation year. Subsection 132.11(6) generally permits a trust that has a December 15 taxation year end to distribute additional income to its unitholders, to the extent that this income is reflected by amounts made payable to these unitholders. Both of these subsections are worded so that rights to these distributions are treated as rights to which subsection 52(6) applies, with the result that there is no capital gain on the satisfaction of these rights.

Paragraph 132.11(1)(*b*) of the Act is amended, consequential to new subsection 132.11(1.1), so that it does not apply where that subsection applies.

New subsection 132.11(1.1) of the Act permits a trust that has a particular taxation year that ends on December 15 because of an election under subsection 132.11(1) to apply in writing to the Minister of National Revenue to revoke the election. If the Minister concurs with the trust's request, the trust's taxation year following the particular taxation year is deemed to begin immediately after the end of the particular taxation year and end at the end of that calendar year (and each subsequent taxation year of the trust is deemed to be determined as if that election had not been made).

These amendments apply to trust taxation years that end after 1999.

Subsections 132.11(4) and (6) are amended to reflect the repeal of subsection 52(6) and the introduction of paragraphs (*g*) and (*h*) of the definition "disposition" in subsection 248(1). As a consequence of these paragraphs, there is no disposition (and, as a consequence no capital gain or loss) that arises on the mere satisfaction of the right to enforce payment from a mutual fund trust.

These amendments apply to the 2000 and subsequent taxation years.

## Clause 131

### Non-Resident-Owned Investment Corporations

ITA
133

Section 133 of the Act provides rules for the taxation of non-resident-owned investment corporations (NROs) on a basis that attempts to approximate the tax treatment that would apply if their non-resident shareholders held investments directly. Pursuant to changes announced in the 2000 Budget, NROs are to be phased out over a three-year period, effective after February 27, 2000.

The 2000 Budget also announced that existing NROs will not be permitted to increase their overall assets or debt during the three-year phase-out period.

The phase out of NROs is given effect through the amended definition "non-resident-owned investment corporation" and the new definition "increase in capital" in subsection 133(8). See the commentary on those definitions for further details.

### Computation of Income

ITA
133(1)(*c*)

Subsection 133(1) of the Act provides rules for computing the income and taxable income of a non-resident-owned investment corporation. Paragraph 133(1)(*c*) provides that the only taxable capital gains and allowable capital losses that are included in computing such a corporation's income are those from dispositions of taxable Canadian property.

Paragraph 133(1)(*c*) is amended, with application after October 1, 1996, to reflect the changes in the definition of "taxable Canadian property" and that definition's relocation from subsection 115(1) to subsection 248(1) of the Act.

## Computation of Income

ITA
133(1)(*d*)

Subsection 133(1) of the Act provides rules for the purposes of determining the income and the taxable income of a non-resident owned investment corporation.

The amendment to paragraph 133(1)(*d*) replaces the reference to the expression "4/3 of" with a reference to the word "twice". It is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

This amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to the word "twice" is to be read as reference to the expression "the fraction that is the reciprocal fraction in paragraph 38(*a*) that applies to the corporation for the year multiplied by". These modifications are required in order to reflect the capital gains/losses rate for the year.

## Definitions

ITA
133(8)

Subsection 133(8) of the Act sets out certain definitions that apply for the purposes of section 133.

"Canadian property"

Paragraph (a) of the definition of "Canadian property" in subsection 133(8) is amended, with application after October 1, 1996, to reflect the changes in the definition of "taxable Canadian property" and that definition's relocation from subsection 115(1) to subsection 248(1) of the Act.

"capital gains dividend account"

The description of M in paragraph (*c*) of the definition of "capital gains dividend account" in subsection 133(8) is amended, with application after October 1, 1996, to reflect the changes in the definition of "taxable Canadian property" and that definition's relocation from subsection 115(1) to subsection 248(1) of the Act.

"non-resident-owned investment corporation"

Paragraph (*e*) of the definition "non-resident-owned investment corporation" in subsection 133(8) provides that a corporation that wishes to be treated as an NRO must have elected to be taxed as an NRO on or before the day that is 90 days after the beginning of its first taxation year that begins after 1971. This paragraph is amended to require the election to have been made on or before the earlier of that day and February 27, 2000. New paragraph (*h*) provides that a corporation created through the amalgamation of two or more corporations, each of which elected in a timely manner under amended paragraph (*e*) to be taxed as an NRO, will be able to elect after February 27, 2000 to be taxed as an NRO. New paragraph (*i*) gives effect to the three-year phase-out period for all NROs, including those created through amalgamations referred to in new paragraph (*h*), by providing that no corporation is an NRO in any taxation year that ends after its last taxation year that begins before 2003. New paragraph (*i*) provides that, if at any time during the three-year phase-out period, a corporation effects an "increase in capital" (as defined in subsection 133(8)), it will lose its status as an NRO for any taxation year that ends after that time.

The amended definition "non-resident-owned investment corporation" applies after February 27, 2000.

"increase in capital"

The new definition "increase in capital" in subsection 133(8) defines an increase in capital to be a transaction in the course of which a corporation issues additional shares or incurs indebtedness, where the transaction has the effect of increasing the total of the corporation's liabilities and the fair market value of all of its shares to an amount that is substantially greater than that total was on February 27, 2000.

Transactions carried out pursuant to an agreement in writing made before February 28, 2000 are exempted from this rule.

A number of consequences that follow from this definition should be noted. First, since the "total" referred to is of both the liabilities of the corporation and the fair market value of all of its shares, an increase in either will increase this "total". For example, if a corporation incurs debt to acquire a new asset, the total fair market value of its shares may remain the same, but its liabilities will increase, thus increasing the "total". Second, an increase in the fair market value of a corporation's shares that results from market appreciation of the value of its assets will not by itself be an "increase in capital", because the definition requires that there be a transaction involving the issuance of shares or the incurring of indebtedness. Finally, since the issuance of additional shares through the payment of stock dividends does not ordinarily increase the fair market value of a corporation's shares or increase its liabilities, such a payment of stock dividends will not be an "increase in capital."

The new definition "increase in capital" applies after February 27, 2000.

## Clause 132

## Non-Resident-Owned Investment Corporations – Transition

ITA
134.1

New section 134.1 of the Act provides special transitional rules to accommodate the phase out of non-resident-owned investment corporations (NROs). The present NRO rules allow an NRO to claim a refund of its 25% refundable tax when it pays dividends to its non-resident shareholders (at which time the dividend withholding tax in Part XIII of the Act applies). However, to access the pool of refundable tax for a given taxation year, the refund mechanism requires dividends to be paid in a subsequent taxation year. Since the amended definition "non-resident-owned investment corporation" in subsection 133(8) calls for the phase-out of NROs over a three-year period, a corporation that ceases to be an NRO would not be able to claim a refund of the 25% refundable tax that it would pay in respect first non-NRO year must be paid to a non-resident person or another NRO.

New section 134.1 applies to corporations that cease to be NROs because of a transaction, event or circumstance that arises in a taxation year of the corporation that ends after February 27, 2000. An election under the section is treated as having been made in a timely manner if it is made on or before the electing corporation's filing-due date for its first taxation year that ends after this amendment receives Royal Assent.

ITA
134.2

New section 134.2 of the Act provides special transitional rules to accommodate the phase-out of non-resident-owned investment corporations (NROs). At present, an NRO that revokes its election to be taxed as an NRO will lose its NRO status as of the end of its previous taxation year. To allow for an orderly phase-out of NROs, new section 134.2 allows an NRO that, after February 27, 2000, revokes its election to be taxed as an NRO, to choose a new taxation year-end, so that NRO status can be maintained up to the time of revocation.

The mechanics of new section 134.2 are as follows. The election to choose a new taxation year-end is provided by new paragraph 134.2(1)(*b*). The time at which an NRO revokes its election to be taxed as an NRO is referred to as the "revocation time"; the taxation year that would have included the revocation time if the NRO had not elected to apply section 134.2 is referred to as the "revocation year"; and the time chosen for the new year-end, which must be within the revocation year and on or before the revocation time, is referred to as the "elected time". Once an election is made under new paragraph 134.2(1)(*b*), the NRO's taxation year that would have included the elected time if the election had not been made is deemed to end immediately before the elected time; a new taxation year of the corporation is deemed to begin at the elected time; and the corporation is deemed to be an NRO for the taxation year that begins at the beginning of the revocation year and ends immediately before the elected time.

the corporation is deemed to begin at the elected time; and the corporation is deemed to be an NRO for the taxation year that begins at the beginning of the revocation year and ends immediately before the elected time.

New section 134.2 applies to revocations made after February 27, 2000. An election made under the section is treated as having been made in a timely manner if it is made on or before the electing corporation's filing-due date for its first taxation year that ends after this amendment receives Royal Assent.

## Clause 133

### Insurance Corporations

ITA
138

Section 138 of the Act sets out detailed rules relating to the taxation of insurance corporations.

### Deductions not Allowed

ITA
138(5)(*b*)(i)

Currently, interest on borrowed money used to acquire designated insurance property for a year may be deducted by an insurer in respect of its insurance business. Interest on borrowed money used to acquire property other than designated insurance property is not deductible. Subparagraph 138(5)(*b*)(i) is amended to allow interest on borrowed money used to acquire property for which designated insurance property is substituted property to be deducted. As well, the deduction is limited to the interest that relates to the period in the year during which the designated insurance property was held by the insurer.

This amendment applies to the 1997 and subsequent taxation years.

ITA
138(5)(*b*)(iv)

Paragraph 138(5)(*b*) of the Act limits the deductibility of interest by resident multinational life insurers and non-resident insurers to those amounts set forth in subparagraphs 138(5)(*b*)(i) to (iv). Subparagraph 138(5)(*b*)(iv) was added to the Act to permit a deduction up to a prescribed amount that was to have been set out in Regulation 2404 proposed as part of the draft Regulations for insurance companies that were published in September 1997. Changes made to the draft *Income Tax Regulations* since their release have eliminated the need for subparagraph 138(5)(*b*)(iv). Subparagraph 138(5)(*b*)(iv) is, therefore, repealed. This amendment applies to the 1997 and subsequent taxation years.

### Deemed Disposition

ITA
138(11.3)

Subsection 138(11.3) of the Act provides for a deemed disposition and reacquisition of property owned by a resident multinational life insurer or a non-resident insurer where property either becomes designated insurance property or ceases to be designated insurance property of the insurer. The purpose of the subsection is to ensure that gains and losses from property accruing while property is designated insurance property are included in computing the insurer's income from carrying on an insurance business in Canada.

New paragraphs 138(11.3)(*d*) and (*e*) ensure that only gains and losses accruing while property is designated insurance property are included in computing an insurer's income.

This amendment applies to the 1997 and subsequent taxation years.

### Transfer of Insurance Business by Non-Resident Insurer

ITA
138(11.5)(b)

Subsection 138(11.5) of the Act sets out the rules that allow a non-resident insurer to transfer, on a tax-deferred basis, an insurance business carried on in Canada to a qualified related corporation. This provision is elective and, in order to be entitled to elect the rollover treatment, the conditions set out in paragraphs 138(11.5)(*a*) to (*d*) must be met. Paragraph 138(11.5)(*b*) requires that the transferor transfer all or substantially all of the property owned by it that was used or held by it in its insurance business in Canada to a qualified related corporation that commences to carry on that insurance business in Canada. The amendment to paragraph 138(11.5)(*b*) is consequential to the definition "designated insurance property" being added to subsection 138(12) and requires that the transferor transfer all or substantially all of its designated insurance property for the year to a corporation that is a qualified related corporation that commences to carry on that insurance business in Canada.

This amendment applies to the 1999 and subsequent taxation years except that, where the taxpayer or the taxpayer's representative so elects and notifies the Minister of National Revenue in writing before 2002 of the election, amended paragraph 138(11.5)(*b*) of the Act will apply to the taxpayer's 1997 and subsequent taxation years.

### Computation of Income of Non-Resident Insurer

ITA
138(11.91)(*e*)

Subsection 138(11.91) provides rules for the purpose of computing the income of a non-resident insurer that commences to carry on an insurance business in Canada at any time in a particular taxation year or that ceases to be exempt from tax under Part I of the Act in a particular taxation year. Paragraph 138(11.91)(*e*) deems an insurer to have disposed, immediately before the beginning of the particular taxation year, of each property owned by the insurer that was used or held by it in the course of carrying on an insurance business in Canada in the year, at its fair market value and to have reacquired it at that time at that fair market value. Paragraph 138(11.91)(*e*) ensures that non-resident insurers will report the appropriate amount of gain or loss from the disposition of property used in carrying on an insurance business in Canada. Paragraph 138(11.91)(*e*) is amended to make reference to property that is designated insurance property. This amendment is consequential to the addition in subsection 138(12) of the definition "designated insurance property", applicable to the 1997 and subsequent taxation years.

This amendment applies to the 1999 and subsequent taxation years except, that where the taxpayer or the taxpayer's representative so elects in writing and the files election with the Minister of National Revenue before 2002, amended paragraph 138(11.91)(*e*) will apply to the taxpayer's 1997 and subsequent taxation years.

## Transfer of Insurance Business by Resident Insurer

ITA
138(11.94)(*b*)

Subsection 138(11.94) of the Act provides rules that apply to the transfer of an insurance business carried on in Canada by an insurer resident in Canada to a corporation resident in Canada that is a subsidiary wholly-owned corporation of the insurer on a tax-deferred or rollover basis. This provision can apply if the conditions set out in paragraphs 138(11.94)(*a*) to (*d*) are met. Paragraph 138(11.94)(*b*) requires that the transferor transfer all or substantially all of the property owned by it that was used or held by it in its insurance business in Canada to a subsidiary wholly-owned corporation that commences to carry on that insurance business in Canada. Paragraph 138(11.94)(*b*) is amended to distinguish a multinational life insurer resident in Canada from other resident insurers. In regards to the former, the defined term "designated insurance property" has been substituted for "property used or held by it in the year in the course of carrying on that insurance business in Canada". In respect of other resident insurers, the rollover provisions continue to apply in respect of "property used or held by it in the year in the course of carrying on that insurance business in Canada".

This amendment applies to the 1999 and subsequent taxation years except that, where the taxpayer or the taxpayer's representative so elects in writing and files the election with the Minister of National Revenue before 2002, amended paragraph 138(11.94)(*b*) will apply to the taxpayer's 1997 and subsequent taxation years.

**Definitions**

ITA
138(12)

"designated insurance property"

The definition of the expression "designated insurance property" in subsection 138(12) of the Act currently directs insurers (other than resident non-life insurers) to use prescribed rules for the 1997 and subsequent taxation years to determine the property falling within its meaning. For earlier years, the expression is to take its meaning from the meaning, in those years, that the expression "property used by it in the year in, or held by it in the year in the course of carrying on an insurance business in Canada" had. The direction to use the prescribed rules is predicated on the proposed *Income Tax Regulations* dealing with the taxation of resident multinational life insurers and non-resident insurers that carry on an insurance business in Canada starting to apply in 1997.

The definition is amended to provide that insurers must use the prescribed rules to determine its meaning only for the 1999 and subsequent taxation years. For earlier years, it is to take its meaning from the meaning that the expression "property used by it in the year in, or held by it in the year in the course of carrying on an insurance business in Canada" had for the 1996 taxation year. This amendment is consequential to the application of the proposed Regulations being delayed to the 1999 and subsequent taxation years.

This amendment applies to the 1997 and subsequent taxation years.

## Clause 134

### Rules Relating to Segregated Funds

ITA
138.1

Section 138.1 of the Act provides rules governing the operation of segregated fund trusts established by insurance companies.

## Deemed Gains and Losses

ITA
138.1(3.1)

Subsection 138.1(3) deems capital gains and capital losses from dispositions of property of a related segregated fund trust to be capital gains or losses of the policyholder or other beneficiary.

New subsection 138.1(3.1) provides a special rule where an amount is deemed under subsection 138.1(3) to be a capital gain or capital loss of a policyholder or other beneficiary (the "taxpayer") in respect of capital gains or losses realized in a taxation year of the related segregated fund trust that includes either February 28, 2000 or October 17, 2000.

If the related segregated fund trust elects, the deemed gains or losses for each of the pre-February 28, 2000 period, the period that begins at the beginning of February 28, 2000 and ends at the end of October 17, 2000 and the period that begins after October 17, 2000 can be treated as having been realized evenly over the number of days in its taxation year, so that the gains or losses in each of the periods will equal that proportion of the gains or losses that the number of days that are in the year of the trust that are in each period is of the number of days in the year.

This subsection applies to taxation years that end after February 27, 2000.

ITA
138.1(3.2)

New subsection 138.1(3.2) of the Act, which is applicable for taxation years that end after February 27, 2000, is consequential on the change to the inclusion rate for capital gains. This new subsection applies to a taxpayer who has a taxation year that begins after October 17, 2000 and who is deemed to have a capital gain or a capital loss by subsection (3) in respect of a capital gain or a capital loss realized by a related segregated fund trust that is deemed not to be a capital gain or loss of the trust.

This new subsection ensures that the inclusion rate for capital gains or capital losses is 3/4 for capital gains or capital losses realized on property disposed of by a related segregated fund trust (the "trust") before February 27, 2000 and is 2/3 for capital gains or capital losses realized on property disposed of by such a trust after February 27, 2000 and before October 18, 2000.

Where the capital gain or capital loss was in respect of capital gains or capital losses from dispositions of property by the trust that occurred before February 28, 2000, 3/2 of the gain or loss is deemed to be a capital gain or capital loss of the taxpayer from the disposition of capital property in the particular taxation year,

Where the capital gain or capital loss was in respect of capital gains or capital losses from dispositions of property by the trust that occurred after February 27, 2000 and before October 18, 2000, 4/3 of the capital gain or loss is deemed to be a capital gain or capital loss of the taxpayer from the disposition of capital property in the particular taxation year.

In any other case, the capital gain or capital loss is deemed to be a capital gain or capital loss of the taxpayer from the disposition of capital property in the particular taxation year.

## Clause 135

### Exclusion from Taxable Canadian Property

ITA
141(5)

Under amendments contained in the 1999 budget bill [S.C. 2000, c.19 (formerly Bill C-25)], new subsection 141(5) of the Act provides for shares issued by a life insurance corporation (or a holding corporation in respect of the life insurance corporation) to be considered, for the purposes of subparagraph 115(1)(*b*)(iv) of the Act, as listed on a stock exchange for up to six months after the demutualization of the life insurance corporation. As a consequence, such a share is not treated as taxable Canadian property during that period. This treatment accommodates non-resident shareholders wishing to dispose of such shares without Canadian income tax consequences before the shares become listed on a prescribed stock exchange.

Because of the relocation of the definition "taxable Canadian property" from subsection 115(1) to subsection 248(1) of the Act, existing subparagraph 115(1)(*b*)(iv) is effectively being replaced by paragraph (*d*) of the definition "taxable Canadian property" in subsection 248(1).

This additional amendment to subsection 141(5) would simply change the reference to subparagraph 115(1)(*b*)(iv) to a reference to paragraph (*d*) of the definition "taxable Canadian property" in subsection 248(1). This amendment is intended to apply after December 15, 1998, in order to be consistent with the 1999 budget bill.

## Clause 136

### Securities Held by Financial Institutions – Definitions

ITA
142.2(1)

Subsection 142.2(1) of the Act defines several terms for the purposes of the rules in sections 142.2 to 142.6 relating to securities held by financial institutions. These terms include "financial institution", "mark-to-market property" and "specified debt obligation". The subsection is amended to specify that the definitions also apply for the purposes of the new rules in section 142.7 of the Act relating to the conversion of foreign bank affiliates to branch operations.

This amendment applies after June 27, 1999.

## Clause 137

### Additional Rules

ITA
142.6

Section 142.6 of the Act contains rules dealing with special situations involving securities held by financial institutions. This section is amended by adding new subsections 142.6(1.1) and (1.2), which deal with securities that a non-resident financial institution (other than a life insurer – dealt with in subsection 138(11.3) of the Act) begins or ceases to use in a Canadian business. These rules complement existing or proposed provisions in subsections 10(12) and (13), 13(9), new 14(14) and (15), paragraph 45(1)(*d*) and new section 76.1 of the Act. An application rule is set out in new subsection 142.6(1.3) and subsection 142.6(2) is modified to take into account the deemed dispositions and acquisitions in new subsections (1.1) and (1.2).

### Ceasing to Use Property in Canadian Business

ITA
142.6(1.1)

New subsection 142.6(1.1) of the Act provides that a non-resident financial institution (other than a life insurer) that at a particular time ceases to use a mark-to-market property or a specified debt obligation in a business in Canada – otherwise than by actually disposing of the property – will be treated as having disposed of the property two moments before the particular time. The provision applies, for example, if a taxpayer removes such property from a business carried on in Canada and begins to use it in a business carried on outside Canada. The taxpayer is deemed to receive, in the course of carrying on the business, proceeds of disposition equal to the property's fair market value and to re-acquire the property at the particular time at a cost equal to those proceeds. Paragraph 142.6(1.1)(*b*) indicates that the rule in subsection 142.4(11) relating to payments received after a disposition is not applicable with respect to this deemed disposition.

### Beginning to Use Property in Canadian Business

ITA
142.6(1.2)

New subsection 142.6(1.2) of the Act provides that a non-resident financial institution (other than a life insurer) that begins to use a mark-to-market property or a specified debt obligation in a business in Canada – other than a property that the taxpayer acquired at that time – is deemed to dispose of the property two moments before the particular time, and to reacquire it at the particular time, for an amount equal to its fair market value.

### Specified Debt Obligation Marked to Market

ITA
142.6(1.3)

New subsection 142.6(1.3) of the Act is an interpretive rule regarding the application of paragraph (*b*) of the definition "mark-to-market property" in subsection 142.2(1) – dealing with specified debt obligations that are marked to market - in the context of new subsection 142.6(1.1). The rule indicates that in determining whether a specified debt obligation is a mark-to-market property, the taxation year in which the property ceases to be used in the Canadian business is deemed to have ended immediately before the time of that cessation. (If financial statements are not prepared for the period thus ending, the reference in the definition to financial statements is to be read as a reference to the statements that it is reasonable to expect would have been prepared if the year ended at that time.) This ensures that a specified debt obligation that is marked to market in the Canadian business will be considered for the purposes of subsection 142.5(1) to have been disposed of when it ceases to be used in the Canadian business, even if it does not continue to be marked to market for financial statement purposes after it is transferred out of the Canadian business.

### Deemed Disposition Not Applicable

ITA
142.6(2)

Subsection 142.6(2) provides that for the purposes of the Act a deemed disposition and reacquisition of a share under certain rules relating to securities held by financial institutions does not affect the time at which a taxpayer is considered to have acquired the share. This provision is amended to add a reference to new subsections 142.6(1.1) and (1.2).

These amendments to section 142.6 apply after June 27, 1999 in respect of an authorized bank and after August 8, 2000 in any other case.

## Clause 138

### Conversion of Foreign Bank Affiliate to Branch

ITA
142.7

New section 142.7 of the Act, which applies after June 27, 1999, provides special, time-limited rules to facilitate foreign banks' transformation of certain Canadian operations, currently carried out through subsidiaries, into Canadian branches of the foreign banks themselves. The section includes three main forms of relief:

- The "branch-establishment rollover" rules allow a tax-deferred transfer of certain eligible property from an eligible subsidiary – a "Canadian affiliate" – to a foreign bank that is starting branch operations in Canada – an "entrant bank." Specific rules deal with particular kinds of property such as specified debt obligations, mark-to-market properties, and properties in respect of which certain reserves would be taken, as well as the consequences of assuming debt obligations.

- The "branch-establishment dividend" rules allow property to flow from a Canadian affiliate to an entrant bank (or to an affiliate resident in the same country as the bank) as a tax-deferred dividend, provided the entrant bank redeploys the dividend proceeds in its Canadian banking business.

- Where the Canadian affiliate is wound up as part of the entrant bank's move into Canada, special loss rules allow the entrant bank to inherit the affiliate's non-capital and net capital losses, on much the same terms as a Canadian corporation inherits the losses of its wound-up Canadian subsidiary. A special rule ensures continuity of amortization schedules in respect of specified debt obligations in these circumstances.

All of these provisions are subject to timing constraints and other conditions described in detail in the following notes.

**Definitions**

ITA
142.7(1)

New subsection 142.7(1) of the Act sets out definitions that apply in section 142.7.

"Canadian affiliate"

A Canadian corporation is a "Canadian affiliate" of an "entrant bank" (see below) at a particular time if the corporation is a bank, a trust company or a non-bank subsidiary in which the entrant bank is authorized to invest under certain provisions of the *Bank Act*, and it has been affiliated at all times from February 11, 1999 to the particular time with either the entrant bank or a foreign bank that is affiliated with the entrant bank at the particular time.

"eligible property"

The definition of a Canadian affiliate's "eligible property" for purposes of new section 142.7 incorporates by reference paragraphs (*a*) to (*g*.1) of the definition, in subsection 85(1.1) of the Act, that applies for transfers under subsection 85(1) of the Act. Provided they are used or held by the Canadian affiliate immediately before the relevant time in carrying on its business in Canada, eligible properties thus generally include:

- capital property;
- Canadian and foreign resource property;
- eligible capital property;
- inventory (other than real property);
- securities and debt obligations that are neither capital, inventory nor mark-to-market properties and that are used or held by the affiliate in the course of an insurance or money-lending business; and
- specified debt obligations (other than mark-to-market properties).

"entrant bank"

An "entrant bank" is a non-resident corporation that is an "authorized foreign bank" (see the notes to subsection 248(1) of the Act, below), or that has applied to the Superintendent of Financial Institutions to become an authorized foreign bank.

"qualifying foreign merger"

A "qualifying foreign merger" is a merger or combination that meets the conditions to be a foreign merger under subsection 87(8.1) of the Act, other than the requirement that the transaction not be the result of the distribution of property to one corporation on the winding-up of another.

**Qualifying Foreign Merger**

ITA
142.7(2)

In general, the rules in new section 142.7 of the Act apply only where a foreign bank has operated a Canadian subsidiary since at least February 11, 1999. In some cases, however, two or more foreign banks may have merged after that date to form a new entrant bank. New subsection 142.7(2) ensures that where there has been a qualifying foreign merger (as defined in subsection 142.7(1)), the merged bank and its Canadian subsidiary or subsidiaries are not disqualified from the benefits of the section.

Specifically, paragraph 142.7(2)(*a*) ensures that the Canadian affiliates of the predecessor foreign banks will be considered Canadian affiliates of the merged foreign bank. It provides that a corporation that would, immediately before the merger, have been a Canadian affiliate of one of the merging banks if the bank were an entrant bank at that time, is deemed to have been affiliated with the merged entrant from February 11, 1999 to the time of the merger. As well, if two or more Canadian subsidiaries of merging entrant banks themselves amalgamate or merge after February 11, 1999, the new merged subsidiary is treated as having been affiliated with the merged entrant bank since that date.

Paragraph 142.7(2)(*b*) provides that if at least one of the predecessor foreign banks has made a timely application to the Office of the Superintendent of Financial Institutions under the terms set out in paragraph 142.7(11)(*a*) – one of the conditions of eligibility for the conversion relief – the merged entity is deemed to have complied with that condition.

## Branch-Establishment Rollover

ITA
142.7(3)

New subsection 142.7(3) of the Act allows an entrant bank's Canadian affiliate to transfer eligible property to the entrant bank on a tax-deferred basis. The model for this "branch-establishment rollover" is the tax-deferred transfer of property by a shareholder to a corporation under existing subsection 85(1) of the Act, and subsection 142.7(3) is structured in large part as a modification of subsection 85(1). The most notable difference between the two types of transaction is that the branch-establishment rollover, unlike the subsection 85(1) transfer, does not require that the transferor (the Canadian affiliate) take back a share of the transferee corporation (the entrant bank) as consideration. Transfers of property in various contexts may be eligible for the rollover, including transfers of property for consideration, as well as distributions of property as dividends-in-kind and on the winding-up of the affiliate.

In order to carry out a branch-establishment rollover, the entrant bank and its Canadian affiliate must meet two special conditions. First, immediately after the transfer the entrant bank must use or hold the eligible property in question in its "Canadian banking business" (see the notes to subsection 248(1) of the Act, below). Second, the entrant bank and the Canadian affiliate must jointly elect in accordance with subsection 142.7(11), described below.

Where these conditions are met, subsections 85(1) (except for paragraph (*e*.2)), (1.1), (1.4) and (5) of the Act apply to the transfer, except that the opening words of subsection 85(1) are modified to refer to the Canadian affiliate and the entrant bank, to remove the requirement that the consideration for the transfer include a share, and to refer to subsection 142.7(11).

It is proposed that a reference to new subsection 142.7(3) be added to subsection 5301(7) of the *Income Tax Regulations*, to ensure carry-over a Canadian affiliate's instalment base to the entrant bank if all or substantially all of the affiliate's property is transferred to the bank.

## Deemed Fair Market Value

ITA
142.7(4)

A number of provisions of the Act, including subsections 15(1) (shareholder benefits), 69(1) (inadequate consideration), 69(4) (shareholder appropriations), 246(1) (conferral of benefits) and 247(2) (transfer pricing adjustments), may apply where a transaction between a corporation and its non-resident shareholder takes place on terms that do not reflect arm's length or fair market value standards. Other provisions such as subsections 69(5) (appropriations to a shareholder on a winding-up) and 52(2) (dividends-in-kind), deem transferred properties in certain circumstances to have been disposed of and acquired at fair market value.

New subsection 142.7(4) of the Act limits the application of these rules where an entrant bank and its Canadian affiliate elect to have new subsection 142.7(3) of the Act apply to the affiliate's transfer of a property to the bank. Specifically, new subsection 142.7(4) provides that for the purposes of the rules listed above, the fair market value of the property transferred is deemed to be the amount agreed to by the affiliate and the entrant bank in their election. This ensures that these rules do not eliminate the benefit of making a rollover election.

### Specified Debt Obligations

ITA
142.7(5)

New subsection 142.7(5) of the Act applies where a Canadian affiliate that is a financial institution (as defined in subsection 142.2(1)) transfers a specified debt obligation (that is not a mark-to-market property) to the affiliate's entrant bank, and the affiliate and the bank elect to transfer the obligation at its tax cost under the new branch-establishment rollover provisions. New subsection 142.7(5) is a continuity rule that deems the entrant bank to be the same corporation as, and a continuation of, the Canadian affiliate in respect of the obligation. This ensures that the tax treatment of the obligation is the same to the entrant bank as it would have been to the Canadian affiliate. Existing subsection 142.6(5) of the Act contains a similar continuity rule for other "rollover" transactions listed in subsection 142.6(6) of the Act.

### Mark-to-Market Property

ITA
142.7(6)

New subsection 142.7(6) of the Act applies where a Canadian affiliate of the entrant bank transfers a mark-to-market property to the entrant bank within the period during which branch-establishment rollovers may be made. Paragraph 142.7(6)(*a*) provides that for the purpose of applying certain of the dividend stop-loss rules in section 112 relating to mark-to-market properties and determining whether certain specified debt obligations constitute "mark-to-market property" within the meaning of the definition in subsection 142.2(1), the entrant bank is deemed to be the same corporation as, and a continuation of, the Canadian affiliate. This provision may be compared to paragraph 87(2)(*e*.5) of the Act, which contains a similar rule.

Paragraph 142.7(6)(*b*) provides that for the purposes of the rule requiring marking-to-market at year-end, the Canadian affiliate's taxation year in which the property was transferred is deemed to have ended immediately before the time of transfer. This ensures that the property is marked-to-market for tax purposes at the time of transfer in spite of the continuity imposed by paragraph (*a*).

**Reserves**

ITA
142.7(7)

New subsection 142.7(7) of the Act provides an election that ensures continuity of reserve treatment upon transfer from a Canadian affiliate to an entrant bank of certain assets and obligations in respect of which reserves have been claimed.

The conditions for reserve continuation are that the affiliate have transferred to the entrant bank the relevant loan or lending asset, right to receive an unpaid amount, or obligation, at fair market value. Further, the entrant bank must begin to use or hold the property or owe the obligation in its Canadian banking business, and both parties must make a joint election under subsection 142.7(11).

If the conditions are met, the reserve continuity provisions apply. Paragraph 142.7(7)(*e*) provides that the taxation year of the Canadian affiliate in which the transfer is made is deemed to have ended immediately before the transfer for the purposes of the deductions under paragraphs 20(1)(*l*) (doubtful or impaired debts), 20(1)(*l*.1) (credit risks under guarantees and other commitments), 20(1)(*m*) (future services), 20(1)(*n*) (unpaid amounts from sale of property in course of business) and 20(1)(*p*) (bad debts) of the Act. The deemed year-end allows the Canadian affiliate to claim a reserve for the year in which the obligation or property is transferred.

Subparagraph 142.7(11)(*f*)(i) provides that an amount deducted by the Canadian affiliate under any of those provisions in that year (and, with respect to subsection 20(1)(*p*), in previous years) is deemed to have been deducted by the entrant bank in its last taxation year that ended before the time of the transfer. This ensures that the reserve amounts will subsequently be included in the entrant bank's income and that the bank will be subject to an income inclusion if there is a subsequent recovery of a bad debt amount. Subsection 20(27) of the Act will typically ensure the entrant's bank's ability to claim a reserve in respect of the transferred obligations and properties. Special rules in subpararaphs 142.7(7)(*f*)(ii) and (iii) ensure continuity with respect to the specific conditions for the reserves under paragraphs 20(1)(*m*) and (*n*). Finally, subparagraph 142.7(7)(*f*)(iv) provides for continuity of the reserves for unpaid amounts provided under paragraphs 40(1)(*a*) (capital property) and 44(1)(*e*) (replacement property) of the Act.

**Assumption of Debt Obligation**

ITA
142.7(8)

In many cases, an entrant bank will assume some or all of its Canadian affiliate's debt obligations. Such an assumption may serve as consideration for the transfer of property by the affiliate to the entrant bank, either on a branch-establishment rollover or otherwise. Where this is the case, new subsection 142.7(8) of the Act applies to govern the tax consequences of the assumption.

New paragraph 142.7(8)(*a*) of the Act provides an election to assume a debt obligation at face value and so can ensure that changes in the value of the obligation that result from, for example, interest rate changes since the affiliate issued or acquired the obligation, do not produce an immediate tax consequence Under subparagraph 142.7(8)(*a*)(i), where a joint election is made in accordance with subsection 142.7(11), for the purpose of determining the consequences of the disposition of the property, the consideration for its transfer is deemed to be the outstanding principal amount of the obligation – referred to as the "settlement amount". The settlement amount is also considered to be the amount of consideration given to the bank for the assumption of the obligation. This is relevant to determining whether or not the assumption gives rise to debt forgiveness consequences or a loss to the affiliate, as well as the consequences to the entrant bank of eventual settlement of the obligation. Subparagraph 142.7(8)(*a*)(ii) provides that assumption of the obligation at the settlement amount (even if that differs from the fair market value of the obligation) is not considered a non-arm's length term. This is relevant for such purposes as the transfer pricing rules in section 247 of the Act.

New paragraph 142.7(8)(*b*) provides an election to ensure that the assumption of a foreign currency debt obligation does not give rise to immediate tax consequences on account of foreign exchange fluctuations. Subparagraph 142.7(8)(*b*)(i) provides for deferral of any foreign exchange gains or losses until the obligation is settled by the entrant bank. Subparagraph 142.7(8)(*b*)(ii) ensures that the election in paragraph 142.7(8)(*a*) operates net of foreign exchange effects.

## Branch-Establishment Dividend

ITA
142.7(9), (10)

New subsections 142.7(9) and (10) of the Act allow an entrant bank to receive (directly or indirectly) a non-taxable dividend from its Canadian affiliate, provided certain conditions are met and provided the proceeds are immediately redeployed in the bank's Canadian branch operation.

New subsection 142.7(9) sets out two conditions for the payment of this "branch-establishment dividend." First, the Canadian affiliate must pay (or must be deemed to pay, as a result of transferring property) a dividend either to the entrant bank or to another person that is affiliated with the entrant bank and that is resident in the same country as the entrant bank. If, for example, an entrant bank does not hold the shares of its Canadian affiliate directly, but rather holds them through a holding company resident in its home country, the Canadian affiliate may pay a branch-establishment dividend to the holding company. Second, the Canadian affiliate and the entrant bank itself – whether or not the dividend is paid directly to the entrant bank – must jointly elect as set out in new subsection 142.7(11) of the Act to have these rules apply to the dividend.

Where these conditions are met, new paragraph 142.7(10)(*a*) of the Act provides that the dividend is deemed not to be a taxable dividend, except for the purposes of the dividend stop-loss rules in subsections 112(3) to (7) of the Act. The recipient of the dividend will thus not be subject to Canadian tax on the dividend, and a subsequent loss to the recipient on the shares of the Canadian affiliate may be adjusted to reflect that exemption.

The purpose of the tax exemption for branch-establishment dividends is to allow entrant banks to redeploy to their new Canadian branch operations the property (particularly retained earnings) that their Canadian affiliates hold in Canada. It is expected that normally the proceeds of any dividend to which these rules apply will immediately be used or held by the entrant bank in its Canadian banking business. Should this not be the case, it is appropriate that the dividend be subject to tax. New paragraph 142.7(10)(*b*) ensures this result by treating the dividend as having formed part of the entrant bank's prior-year "investment allowance" under paragraph 219(1)(*g*) of the Act, and thus including it in the bank's Part XIV branch tax base for the current year. To the extent the dividend proceeds have been redeployed to the entrant bank's Canadian banking business, they will figure in the bank's current-year investment allowance, and will be deducted from the branch tax base for the current year; to the extent they have not been so redeployed, they will be subject to the branch tax (which is comparable to withholding tax on a dividend).

In determining the addition to the paragraph 219(1)(*g*) amount, it should be noted that where a branch-establishment dividend is paid by, or arises from, a branch-establishment rollover of eligible property, (such as, for example, in the case of a dividen-in-kind or a transfer that is deemed to be dividend) the amount of the addition is reduced by any latent gain on the property. Since the amount of the dividend in this case will typically be the net value of the property transferred, this rule ensures that the gain is deferred as long as long as the property remains deployed in the entrant bank's Canadian banking business.

## Elections

ITA
142.7(11)

New subsection 142.7(11) of the Act sets out the procedural requirements for the various elections provided in the section. A number of these requirements are time limits determined by reference to the day that the enacting legislation receives royal assent. In general terms, an election is valid only if: (a) the entrant bank has formally applied, within 6 months after royal assent, for regulatory approval to operate in branch form in Canada; (b) the election is duly made on or before the earlier of the entrant bank's and the Canadian affiliate's filing-due date for the year in which the dividend or transfer was paid or made, as the case may be; and (c) the dividend, transfer, assumption or other transaction in respect of which the election is made is effected during the period that (i) begins on the day the regulatory order has been made allowing the entrant bank to start operations in Canada in branch form, and (ii) ends on the earlier of one year after the date of that order and three years after Royal Assent to the legislation giving effect to this measure. A further condition ensures that even if an entrant bank receives an order to carry on business as a branch prior to Royal Assent, the deadline in (ii) will not be earlier than one year after Royal Assent.

### Winding-Up of Canadian Affiliate: Losses

ITA
142.7(12)

New subsection 142.7(12) of the Act sets out rules that give an entrant bank access to losses of its Canadian affiliate, where the affiliate is wound up as part of the entrant bank's commencement of Canadian operations.

Paragraphs 142.7(12)(*a*) through (*c*) set out the conditions that must be met for subsection (8) to apply.

First, within the time limit set out in paragraph 142.7(11)(*c*), the Canadian affiliate must:

- in the case of a bank or federal trust company, have been the subject of an order commencing a wind-up (section 345 of the *Bank Act* or section 350 of the *Trust and Loan Companies Act*) or been dissolved (section 342 of the *Bank Act* or section 347 of the *Trust and Loan Companies Act*); and

- in the case of any other corporation, have been wound up under the terms of the corporate law that governs it.

Second, the entrant bank must carry on all or part of the Canadian business that the Canadian affiliate formerly carried on.

Third, the Canadian affiliate and the entrant bank must make a joint election in accordance with subsection 142.7(11).

Where these conditions are met, new subsection 142.7(12) allows the entrant bank to treat the Canadian affiliate's unused non-capital losses and net capital losses as its own, in a similar manner as existing subsections 88(1.1) and (1.2) of the Act give a taxable Canadian corporation access to the losses of its wound-up Canadian subsidiary. The main features of these new rules are as follows:

- The Canadian affiliate's unused non-capital loss for a taxation year (the "loss year") from carrying on a business (the "loss business") in Canada is treated as a loss of the entrant bank from the loss business for its taxation year in which the Canadian affiliate's loss year ended. The loss must not have been otherwise deducted by either the affiliate or another entrant bank in respect of the affiliate. Losses in respect of a claim by the Canadian affiliate under section 110.5 (taxable income addition for foreign tax credit purposes) are also accommodated. (Paragraph 142.7(12)(*d*))

- Similarly, the Canadian affiliate's unused net capital loss for a taxation year is treated as a net capital loss of the entrant bank for its taxation year in which the Canadian affiliate's loss year ended. (Paragraph 142.7(12)(*f*))

- If control of the Canadian affiliate or of the entrant bank is acquired at any time, the affiliate's non-capital losses are streamed, and its net capital losses are blocked:

    - Pre-acquisition non-capital losses of the affiliate are usable by the entrant bank in a given post-acquisition year only if it or the affiliate carries on the loss business throughout the year, and only to the extent of the income from that or a similar business (defined in a manner identical to that set out for Canadian corporations in existing paragraph 88(1.1)(*e*)). (Paragraph 142.7(12)(*e*))

    - The entrant bank may not use pre-acquisition net capital losses of the affiliate in any post-acquisition year. (Paragraph 142.7(12)(*g*))

- Where a loss of the Canadian affiliate would be treated as a loss of the entrant bank for a year that begins after the date of the affiliate's dissolution order (or after its winding-up commences), the entrant bank can choose to treat the loss as having arisen in its immediately preceding year. This may enable the entrant bank to use the affiliate's final-year loss in its own first taxation year that begins after the dissolution of the affiliate. (Paragraph 142.7(12)(*h*))

## Winding-up of Canadian Affiliate – Stop Loss

ITA
142.7(13)

New subsection 142.7(13) of the Act modifies the application of various stop loss rules in the Act that suspend the recognition of losses when properties are transferred to an affiliated person. The provision applies if at any time a Canadian affiliate elects to transfer property to its entrant bank using the rollover provisions in subsection 142.7(3) or the entrant bank elects to use the losses of the subsidiary under subsection 142.7(12). Where either of these elections has been made, the winding-up of the affiliate and associated transfer of assets to the entrant bank is not a fully taxable transaction; therefore, it is not appropriate to provide the relief from the stop loss rules normally associated with taxable wind-ups. Rather, it is more appropriate that the stop loss rules apply principles such as those applicable in a tax-deferred wind-up under subsection 88(1) of the Act.

Paragraphs 142.7(13)(*a*) and (*b*) apply in respect of a transfer of property by a Canadian affiliate to its entrant bank or to any person who does not deal at arm's length with the entrant bank. Paragraph 142.7(13)(*a*) directs that in applying the stop loss rules in subsections 13(21.2), 14(12), 18(15) and 40(3.4) of the Act in respect of losses triggered by such a transfer, each stop loss rule is to be read without reference to the provision that would otherwise end the deferral of the loss upon the winding-up of the affiliate. Paragraph 142.7(13)(*b*) provides that where the transfer has been made on the winding-up of the affiliate, the rule in subsection 69(5) that would otherwise exclude the operation of the above stop loss rules does not apply. Finally, paragraph 142.7(13)(*c*) provides that for the purpose of applying those stop loss rules in respect of any property disposed of by the affiliate, the entrant bank is deemed, upon the dissolution of the affiliate, to be a continuation of the affiliate. This ensures, for example, that where a loss was suspended in the affiliate upon a transfer of property to the entrant bank, the suspended loss will effectively be transferred to the entrant bank, which may claim the loss when the property is transferred to a non-affiliated person.

## Winding-Up of Canadian Affiliate – SDOs

ITA
142.7(14)

New subsection 142.7(14) of the Act is a continuity rule that applies where a Canadian affiliate of an entrant bank is wound-up and all or part of its business is transferred to the entrant bank in accordance with the conditions in paragraphs 142.7(12)(*a*) to (*c*). In those circumstances, for the purpose of the amortization rules relating to specified debt obligations in paragraphs 142.4(4)(*c*) and (*d*) of the Act, if the parties make a joint election under the terms of subsection 142.7(11), the entrant bank is deemed to be the same corporation as, and a continuation of, the Canadian affiliate. This ensures that, where a specified debt obligation was previously disposed of by the Canadian affiliate and the residual portion of the resulting gain or loss has been amortized over the remaining term to maturity of the obligation, the amortization schedule is not disrupted by the transfer of the affiliate's business to the entrant bank.

To implement this rule, it is proposed that section 9204 of the *Income Tax Regulations* be amended to extend the winding-up rule in subsection 9204(2) to the situation described in new subsection 142.7(14) of the Act and to exclude that situation from the rule in subsection 9204(5) of the Regulations dealing with cessation of business. On the other hand, it is proposed that this latter rule be extended to apply whenever a non-resident ceases to carry on all or substantially all of the part of its business that was carried on in Canada.

## Clause 139

### Registered Retirement Savings Plans

ITA
146

Section 146 of the Act provides rules relating to registered retirement savings plans (RRSPs).

### Definitions

ITA
146(1)

"qualified investment"

The definition "qualified investment" in subsection 146(1) of the Act sets out the types of property that a trust governed by a registered retirement savings plan (RRSP) is permitted to hold.

Paragraph (*b*) of the definition provides that a bond, debenture, note or similar obligation of a corporation the shares of which are listed on a prescribed stock exchange in Canada is a qualified investment for a trust governed by an RRSP. This paragraph is amended to provide that a bond, debenture, note or similar obligation issued by an authorized foreign bank and payable at a branch in Canada of that bank is also a qualified investment for such a trust. This amendment is part of a set of amendments concerning foreign bank branches.

This amendment applies after June 27, 1999.

## Clause 140

### Registered Education Savings Plans

ITA
146.1

Section 146.1 of the Act provides rules relating to registered education savings plans (RESPs).

### Definitions

ITA
146.1(1)

"qualified investment"

The definition "qualified investment" in subsection 146.1(1) of the Act sets out the types of property that a trust governed by an RESP is permitted to hold.

Paragraph (*b*) of the definition provides that a bond, debenture, note or similar obligation of a corporation the shares of which are listed on a prescribed stock exchange in Canada is a qualified investment for a trust governed by an RRSP. This paragraph is amended to provide that a bond, debenture, note or similar obligation issued by an authorized foreign bank and payable at a branch in Canada of that bank is also a qualified investment for such a trust. This amendment is part of a set of amendments concerning foreign bank branches.

This amendment applies after June 27, 1999.

## Clause 141

### Registered Retirement Income Funds

ITA
146.3

Section 146.3 of the Act provides rules relating to registered retirement income funds (RRIFs).

**Definitions**

ITA
146.3(1)

"qualified investment"

The definition "qualified investment" in subsection 146.3(1) of the Act sets out the types of property that a trust governed by an RRIF is permitted to hold.

Paragraph (*b*) of the definition provides that a bond, debenture, note or similar obligation of a corporation the shares of which are listed on a prescribed stock exchange in Canada is a qualified investment for a trust governed by an RRSP. This paragraph is amended to provide that a bond, debenture, note or similar obligation issued by an authorized foreign bank and payable at a branch in Canada of that bank is also a qualified investment for such a trust. This amendment is part of a set of amendments concerning foreign bank branches.

This amendment applies after June 27, 1999.

## Clause 142

### Deferred Profit Sharing Plans

ITA
147

Section 147 of the Act contains rules relating to deferred profit sharing plans (DPSPs).

**Order of Disposal of Shares**

ITA
147(10.5)

Subsection 147(10.5) of the Act contains a special ordering rule which provides that, for the purposes of subsection 147(10.4) of the Act, identical shares are considered to have been disposed of in the order in which they were acquired. Subsection 147(10.4) provides that, in certain circumstances, an employee who receives employer shares on withdrawing from a DPSP must include in income in the year the shares are disposed of the excess of the fair market value of the shares at the time of the withdrawal over the cost amount of the shares to the DPSP.

Subsection 147(10.5) is repealed. This is consequential to subsection 7(1.3) of the Act being amended to have that subsection apply for the purposes of subsection 147(10.5) with respect to shares acquired after February 27, 2000, and to shares acquired before February 28, 2000 but not disposed of before that date. (See the commentary on subsection 7(1.3) for further details.)

## Clause 143

## Amount of Employee's Pension Contributions Deductible – Service After 1989

ITA
147.2(4)(*a*)

Subsection 147.2(4) of the Act provides rules that govern the deductibility of employee contributions to registered pension plans (RPPs). Paragraph 147.2(4)(*a*) allows an individual to deduct contributions made after 1990 to an RPP in respect of years after 1989, to the extent that the contributions are made in accordance with the terms of the plan as registered. This rule applies whether a contribution is made under a money purchase provision or a defined benefit provision, and whether a contribution is a current service contribution or a past service contribution.

Paragraph 147.2(4)(a) is amended to allow an individual to deduct, in addition to the contributions described above, prescribed eligible contributions. Draft subsection 8501(6.2) of the *Income Tax Regulations* prescribes, for this purpose, certain employee contributions that are made under a defined benefit provision of an RPP pursuant to an arrangement under which members of the plan make contributions towards an unfunded liability under the plan. For further details, refer to the commentary on draft subsections 8501(6.1) and (6.2) of the Regulations in Appendix I.

This amendment applies to contributions made after 1990.

## Clause 144

### Registered Pension Plans – Transfers

ITA
147.3

Section 147.3 of the Act provides rules governing the transfer of funds from registered pension plans (RPPs) to registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs) and other RPPs.

### Transfer to RPP, RRSP or RRIF for Spouse on Marriage Breakdown

ITA
147.3(5)(*a*)

Subsection 147.3(5) of the Act permits the direct transfer of a lump sum amount from an RPP to another RPP, an RRSP or a RRIF for the benefit of an individual who is a spouse or common-law partner or former spouse or common-law partner of a plan member, where the individual is entitled to the amount pursuant to a court order or written agreement relating to a division of property on the breakdown of their marriage or common-law partnership.

Paragraph 147.3(5)(*a*) is amended to deny the transfer of an amount relating to actuarial surplus. This change is consistent with the transfer rules set out in subsections 147.3(4) and (7), which do not permit a plan member's share of an actuarial surplus to be transferred tax-free to another registered plan.

This amendment applies to transfers that occur after November 1999.

## Transfer Where Money Purchase Plan Replaces Money Purchase Plan

ITA
147.3(7.1)

New subsection 147.3(7.1) of the Act is introduced to permit surplus to be transferred directly from a money purchase provision of an RPP to a money purchase provision of another RPP, where the second plan replaces all or part of the first plan. Subsection 147.3(7.1) is intended to apply to situations involving the reorganization of a money purchase RPP, such as the splitting of one plan into two or more plans or the transfer of one group of employees from one plan to another. The subsection ensures that money purchase surplus can be transferred directly to a replacement money purchase plan. This will enable an employer to use the surplus, for example, to satisfy its obligations to make contributions under the money purchase provision, to make additional allocations to plan members or to pay plan expenses.

Subsection 147.3(7.1) provides that the term "surplus" has the meaning assigned by the *Income Tax Regulations*.
Subsection 8500(1) of the Regulations, in conjunction with draft subsection 8500(1.1), defines "surplus" for this purpose. "Surplus" under a money purchase provision of an RPP is the portion of the unallocated amount held under the provision that is not attributable to forfeited amounts, employer contributions that will be allocated to members as part of the regular allocation of contributions, or to certain earnings of the plan. Generally, a money purchase surplus would exist only if actuarial surplus was originally transferred from a defined benefit provision of an RPP and if the actuarial surplus was not credited to the members' accounts under the money purchase provision at the time of the transfer.

The following conditions must be met in order for the subsection to apply with respect to the transfer of money purchase surplus:

- the surplus must be transferred in conjunction with the transfer of amounts on behalf of all or a significant number of members of the transferor plan whose money purchase benefits are being replaced by money purchase benefits under the recipient plan; and

- the transfer must be approved in writing by the Minister of National Revenue.

Appendix I contains consequential amendments to Parts LXXXIII and LXXXV of the *Income Tax Regulations* to reflect the introduction of subsection 147.3(7.1).

New subsection 147.3(7.1) applies to transfers that occur after 1998.

## Transfer Where Money Purchase Plan Replaces Defined Benefit Plan

ITA
147.3(8)

Subsection 147.3(8) of the Act permits, in certain circumstances, the direct transfer of property from a defined benefit provision of an RPP to a money purchase provision of another RPP. Subsection 147.3(8) is intended to accommodate the transfer of actuarial surplus where a defined benefit RPP is replaced by a money purchase RPP. One of the conditions that must be met in order for the subsection to apply is that the recipient plan must provide that the surplus be used to satisfy the obligation of employers to make contributions under the recipient plan.

Subsection 147.3(8) is amended to eliminate the condition that the surplus be used to satisfy employer contribution obligations. This will permit the surplus to be used for other purposes relating to the operation of the plan, such as to pay plan expenses or to make additional allocations to plan members. In addition, subsection 147.3(8) is amended to clarify that the provision is intended to apply only to accommodate the transfer of actuarial surplus. It should be noted that paragraph 8506(2)(*c*) of the *Income Tax Regulations* prohibits employer contributions to a money purchase provision where there is a surplus under the provision.

These amendments apply to transfers that occur after 1990.

## Clause 145

### Miscellaneous Exemptions

ITA
149

Section 149 of the Act exempts certain taxpayers from tax under Part I of the Act and provides special rules for such taxpayers.

### Corporations Owned by Governments and Municipalities in Canada

ITA
149(1)(*d*) to (*d*.4) and (*d*.6)

Paragraphs 149(1)(*d*) to (*d*.6) of the Act exempt from tax the taxable income of any corporation, commission or association 100% (or in some instances 90%) of the shares or capital of which is owned by the federal government, a provincial government or a municipality in Canada. The exemption also applies to a wholly-owned subsidiary of such a corporation, commission or association. Paragraphs 149(1)(*d*) to (*d*.4) and (*d*.6) are amended to clarify that the ownership test referred to in those paragraphs can be met through combined ownership. For example, where the federal government and a provincial government each owns 50% of the shares of a corporation, the taxable income of the corporation will be exempt by virtue of paragraph 149(1)(*d*).

These amendments apply to taxation years and fiscal periods that begin after 1998. However, a corporation, commission or association may, through an election in writing filed with the Minister of National Revenue within six months after this amendment is assented to, choose that these amendments apply only after November 1999.

### Pension Corporations

ITA
149(1)(*o*.2)

Paragraph 149(1)(*o*.2) of the Act exempts from tax certain types of corporations involved with pension fund administration and investments if all the shares and rights to acquire shares of the corporation are owned by, or in certain cases held exclusively for the benefit of, one or more registered pension plans. Subparagraph 149(1)(*o*.2)(ii) limits the activities of the corporation to investing in real property or other permitted investments and certain other permitted activities in respect of real property that is capital property of the corporation, a registered pension plan or another corporation described in subparagraphs 149(1)(*o*.2)(ii) and (iv).

Subparagraph 149(1)(*o*.2)(ii) is amended so that a corporation will not lose its tax-exempt status solely because of an investment in an interest of a partnership that limits its activities to acquiring, holding, maintaining, improving, leasing or managing capital property that is real property or an interest in real property owned by the partnership.

This amendment applies to taxation years that end after 2000.

### Exception

ITA
149(1.1)

Subsection 149(1.1) of the Act stipulates that, in order for a corporation, commission or association to benefit from the exemption provided under any of paragraphs 149(1)(*d*) to (*d*.6), only the federal government, a province or a municipality in Canada can have the right to acquire shares or capital of the corporation, commission or association. The amendment to subsection 149(1.1) ensures that tax-exempt entities that need only to meet a 90% (rather than a 100%) ownership test would still quality for the exemption under paragraph 149(1)(*d*.2), (*d*.3) or (*d*.5), as the case may be, provided that non-exempt entities do not, collectively, own shares or capital (or rights to such shares or capital) in excess of 10%.

This amendment applies to taxation years and fiscal periods that begin after 1998. However, a corporation, commission or association may, through an election in writing filed with the Minister of National Revenue within six months after this amendment is assented to, choose that this amendment apply only after November 1999.

**Election**

ITA
149(1.11)

A number of entities which were taxable before 1999 became, as a result of the amendment to paragraph 149(1)(*d*) of the Act and the addition of paragraphs 149(1)(*d*.2) to (*d*.4), exempt under those paragraphs with respect to their post-1998 fiscal periods. This result, which is appropriate from a tax policy standpoint, may not be beneficial for a limited number of entities since it would trigger the application of subsection 149(10) which provides, among other things, that any gain or loss that accrued before the entities become tax-exempt are to be recognized before the change of status. Accordingly, this amendment allows an entity, which has become exempt because of any of paragraphs 149(1)(*d*.2) to (*d*.4) but which was taxable for its last taxation year that began before 1999, to elect in writing before 2002 to retain its taxable status provided there has been no change in the direct or indirect control of the entity since the beginning of the entity's first taxation year that began after 1998.

This amendment applies to taxation years and fiscal periods that begin after 1998. However, a corporation, commission or association may, through an election in writing filed with the Minister of National Revenue within six months after this amendment is assented to, choose that this amendment apply only after November 1999.

**Income Test**

ITA
149(1.2)

Subsection 149(1.2) of the Act excludes, for the purposes of paragraphs 149(1)(*d*.5) and (*d*.6), certain income from the determination of whether more than 10% of the income of an entity to which one of those two paragraphs applies is derived from activities carried on outside the geographical boundaries of the municipality or municipalities that own the entity. The amendment ensures that income from activities carried on in a province by an entity, as a producer of electrical energy or natural gas or as a distribution of electrical energy, heat, natural gas or water, is not included in the determination where those activities are regulated under the laws of the province.

This amendment applies to taxation years and fiscal periods that begin after 1998. However, a corporation, commission or association may, through an election in writing filed with the Minister of National Revenue within six months after this amendment is assented to, choose that this amendment apply only after November 1999.

### Clause 146

### National Arts Service Organizations

ITA
149.1(6.4)

Subsection 149.1(6.4) of the Act provides that a national arts service organization that is designated by the Minister of Canadian Heritage and registered by the Minister of National Revenue as meeting prescribed criteria shall be treated, for income tax purposes, as if it were a registered charity that is designated as a charitable organization. To this end, that subsection includes references to various provisions of the Act that apply to a charitable organization. The amendment corrects an oversight by adding a reference to subsection 241(3.2) which deals with the communication of information relating to a registered charity.

This amendment comes into force on Royal Assent.

### Clause 147

### Filing Returns of Income – Corporations

ITA
150(1)(*a*)(i)(B)

Subsection 150(1) of the Act describes those persons who must file a return of income under Part I of the Act, and sets out the time limits for filing that apply to various kinds of taxpayers.

Under paragraph 150(1)(*a*), a corporation is required to file a return of income for a taxation year only under certain circumstances. First, a corporation must file a return for a year if, in the year, it is resident in Canada, carries on business in Canada, has a taxable capital gain or disposes of a taxable Canadian property. Second, a corporation must file a return for any year for which tax under Part I is payable by the corporation, or would be payable but for a tax treaty.

Amended clause 150(1)(*a*)(i)(B) ensures that a non-resident corporation that carries on business in Canada in a year is not required to file a return for the year if the only revenue the corporation has from the business is for the provision of acting services in Canada, and tax was paid by or on behalf of the corporation under new subsection 212(5.1) of the Act (23% withholding). For more information on new subsection 212(5.1), readers may refer to the notes to that provision.

This amendment applies to the 2001 and subsequent taxation years.

## Clause 148

### Electronic Filing

ITA
150.1(5)

Section 150.1 of the Act provides for the use of electronic media for filing tax returns. The amendment to subsection 150.1(5) is consequential to the repeal of the surtax imposed on individuals under Part I.1 of the Act (see commentary on that Part).

This amendment applies to the 2001 and subsequent taxation years.

## Clause 149

### Assessment and Reassessment

ITA
152(4)(*b*)

Subsection 152(4) of the Act provides the time limits within which assessments, reassessments and additional assessments may be made. Paragraph (*b*) describes the circumstances in which the Minister of National Revenue may, after a taxpayer's normal reassessment period for a taxation year, assess or reassess tax payable under Part I of the Act for the year. The subsection is amended by adding new subparagraph 152(4)(*b*)(iii.1), to allow the Minister under certain circumstances to assess or reassess, within three years after the end of the normal assessment period, the tax of a non-resident that carries on business in Canada. Such a (re)assessment may be made if it results from the taxpayer's allocation of revenue or expenses in respect of the Canadian business (unless the revenue or expenses relate solely to the Canadian business and are fully documented in Canada), or from a notional transaction between the taxpayer and its Canadian business, which transaction is recognized under the Act or a tax treaty. An example of such a notional transaction is a "branch advance" contemplated by new section 20.2 of the Act, which applies to a foreign bank that operates a branch in Canada. New subparagraph 152(4)(*b*)(iii.1) will treat such allocations and notional transactions in the same manner as transactions between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length, which are covered by subparagraph (iii).

New subparagraph 152(4)(*b*)(iii.1) of the Act applies to the 2000 and subsequent taxation years.

### Reassessments

ITA
152(6)

A number of provisions of the Act allow a taxpayer to carry back amounts from one taxation year to reduce the taxpayer's income, taxable income or tax for a prior year. Where an amount is carried back under one of these provisions, subsection 152(6) of the Act directs the Minister of National Revenue to reassess the taxpayer's tax for the relevant year or years to take the carry-back into account.

Subsection 152(6) is amended to include in its list of carry-back provisions new section 119 and new subsections 126(2.21) and (2.22) and 128.1(8) of the Act. These additions apply to taxation years that end after October 1, 1996. As well, a taxpayer who wishes to use the newly-added provisions will be deemed to have filed the prescribed form required under subsection 152(6) in a timely manner if the form is filed on or before the later of the normal deadline for filing the form and the taxpayer's filing-due date for the taxation year that includes the day on which Royal Assent for these amendments is received.

## Reassessment Where Amount Included in Income Under Subsection 91(1) is Reduced

ITA
152(6.1)

New subsection 152(6.1) of the Act is consequential to the extension of the deductible loss carryover period for foreign accrual property losses in the description of F in the definition "foreign accrual property income" in subsection 95(1) and section 5903 of the *Income Tax Regulations*. Subsection 152(6.1) provides for the reassessment of all relevant taxation years (other than taxation years preceding the particular taxation year) where the taxpayer has filed a prescribed form carrying back a deductible loss from a subsequent taxation year that reduces the taxpayer's income for the particular year under subsection 91(1).

New subsection 152(6.1) applies to taxation years of a foreign affiliate that begin after November 1999.

## Assessment for the Purpose of Federal-Provincial Agreements

ITA
152(10)

New subsection 152(10) of the Act provides that an amount of tax for which adequate security is accepted by the Minister of National Revenue under subsection 220(4.5) or (4.6) of the Act shall not be treated as an amount assessed under the Act, for the period during which such security is accepted, for the purpose of any agreement entered into by the federal government under section 7 of the *Federal-Provincial Fiscal Arrangements Act*.

New subsection 152(10) applies to taxation years that end after October 1, 1996.

## Clause 150

### Reassessments

Clause 150 enacts a special reassessment rule that applies to individuals who ceased to be resident in Canada, and to certain trust distributions of taxable Canadian property to non-resident beneficiaries, during the period that begins after October 1, 1996 and ends two years before the day on which the legislation giving effect to this measure receives Royal Assent. The time during this period at which the individual ceased to be resident in Canada or the trust distributed the property is referred to in the provision as the "particular time".

This rule extends the normal reassessment period under section 152(3.1) of the Act for any taxation year that ends at or after the "particular time". The reassessment period is deemed to end on the later of two days: the day that it would have ended in the absence of this rule, and the day that is one year after Royal Assent. This ensures that the proposals on taxpayer migration and trust distributions, announced on October 1, 1996, and effective from that date, can be applied equitably in respect of cessations of residence and trust distributions that occurred shortly after that date, as well as those that occurred more recently.

## Clause 151

### Withholding

ITA
153

Section 153 of the Act requires the withholding of tax from certain payments, described in paragraphs 153(1)(*a*) to (*t*). The person making such a payment is required to remit the amount withheld to the Receiver General on behalf of the payee. Certain prescribed persons can make that remittance by depositing the withheld amount to the Receiver General's account at certain financial institutions, defined by reference to subsection 190(1).

ITA
153(1)(*a*)

Paragraph 153(1)(*a*) of the Act requires prescribed withholding in respect of all amounts paid as salary, wages or other remuneration. This paragraph is amended to ensure that there is no withholding pursuant to this paragraph on income earned from the provision of film and video acting services by non-resident actors who are employed in Canada. That income is now subject to withholding under amended subsection 215(1) of the Act.

This amendment applies in respect of amounts paid, credited or provided after 2000.

ITA
153(1)(*g*)

Paragraph 153(1)(*g*) of the Act authorizes prescribed withholding in respect of all amounts paid as fees, commissions or other amounts for services. This paragraph is amended to ensure that there is no withholding pursuant to this paragraph on income earned from the provision of film and video acting services in Canada by non-resident actors or corporations related to them. This income is now subject to withholding under amended subsection 215(1) of the Act.

This amendment applies in respect of amounts paid, credited or provided after 2000.

Subsection 153(1) is also amended to change the special purpose definition of financial institution with a reference to the new term "designated financial institution", which is defined in new subsection 153(6) of the Act. The language of subsection 153(1) is also updated, without changing its effect.

This amendment applies after June 27, 1999.

"Designated Financial Institution"

ITA
153(6)

New subsection 153(6) defines the term "designated financial institution", which is used in subsection 153(1), as a bank (other than an authorized foreign bank subject to the restrictions in subsection 524(2) of the *Bank Act* – i.e. one which operates as a so-called lending branch), a trust company and a deposit-taking mortgage lender. The definition effectively includes only those authorized foreign banks that operate a so-called full-service branch in Canada. New subsection 153(6) applies after June 27, 1999.

## Clause 152

### Tax Instalments

ITA
156.1(1)

"net tax owing"

Subsection 156.1(1) of the Act sets out definitions that are relevant in determining whether an individual is required to make tax instalments. The amendment to the definition "net tax owing" is consequential to the repeal of the surtax imposed on individuals under Part I.1 of the Act (see commentary on that Part).

This amendment applies to the 2001 and subsequent taxation years.

## Clause 153

### Payment by Corporations

ITA
157(1), (2.1)

Section 157 of the Act sets out the required payment dates for corporate income tax instalments and for any balance of corporate income tax payable. The list, in subparagraph 157(1)(*a*)(i), of Parts in respect of which monthly instalments are required is amended by adding a reference to new Part XIII.1 (the "additional tax on authorized foreign banks," or "branch interest tax"). The same reference is also added to the rules in paragraph 157(1)(*b*) that relate to the payment of the remainder of tax owing. As a result, a foreign bank's payments of Part XIII.1 tax will follow the same schedule as its payments of Part I tax.

Subsection 157(2.1) of the Act exempts a corporation from the requirement to pay its tax for a taxation year by instalments, where either the total of its taxes payable for the year or its "first instalment base" (defined by Regulation) is $1,000 or less. The subsection is amended to include tax under new Part XIII.1 among the taxes covered by this rule.

These amendments apply to the 2001 and subsequent taxation years. More information on new Part XIII.1 itself is set out in the notes to new section 218.2 of the Act.

## Clause 154

### Election on Emigration

ITA
159(4) and (4.1)

Subsections 159(4) and (4.1) of the Act allow an individual who has ceased to be resident in Canada to elect to pay any tax resulting from the deemed disposition of property under subsection 128.1(4) of the Act in up to six annual instalments, provided the individual gives the Minister of National Revenue adequate security.

The present amendments include, in new subsections 220(4.5) and 220(4.6) of the Act, more comprehensive and more liberal security rules than these. Subsections 159(4) and (4.1) are therefore repealed, with application to individuals who cease to be resident in Canada after October 1, 1996.

ITA
159(6.1)

Subsection 159(6.1) of the Act permits payments of a trust's tax liability resulting from a deemed disposition under paragraph 104(4)(*a*), (*a*.1), (*b*) or (*c*) to be paid (with interest) over 10 years.

Subsection 159(6.1) is amended so that this rule also applies in regard to a trust's tax liability resulting from a deemed disposition under new paragraphs 104(4)(*a*.2) to (*a*.4), described in the notes above.

This amendment applies to the 2000 and subsequent taxation years.

## Clause 155

### Interest – Effect of Carryback of Loss, etc.

ITA
161(7)(*a*)

Section 161 of the Act provides for the payment of interest on outstanding amounts of tax payable under Part I of the Act, as well as on late or deficient instalments in respect of such tax.

Subsection 161(7) provides that, where the amount of tax payable for a taxation year is reduced because of certain deductions or exclusions arising from tax credits, the carryback of losses, or events in subsequent years, interest on any unpaid tax for the taxation year is calculated without regard to the reduction until the latest of several dates.

Paragraph 161(7)(*a*) is amended to include in its list of deductions and exclusions: a deduction under new section 119 of the Act in respect of the disposition of a taxable Canadian property of the taxpayer in a subsequent year; a deduction under new subsection

126(2.21) or (2.22) of the Act in respect of a disposition in a subsequent year; and deductions under new subsections 128.1(6) to (8) of the Act in respect of an election in a subsequent year.

These amendments apply to taxation years that end after October 1, 1996.

## Clause 156

### Refunds

ITA
164(1)

Subsection 164(1) of the Act provides rules governing refunds of overpayments of tax.

Subparagraph 164(1)(*a*)(ii) of the Act is amended to authorize the Minister of National Revenue to refund all or part of a corporation's claim for a taxation year of a Canadian Film or Video Production Tax Credit under section 125.4 or of a Film or Video Production Services Tax Credit under section 125.5 of the Act, before having issued an assessment in respect of the corporation for the year.

Former subparagraph 164(1)(*a*)(ii) of the Act is re-numbered as subparagraph (iii) and, along with subparagraph (i), is amended to conform to the language in amended subparagraph (ii). Paragraph 164(1)(*b*) is amended to reflect the re-numbering of subparagraph 164(1(*a*)(ii) as subparagraph 164(1)(*a*)(iii).

Amended subsection 164(1) of the Act applies to the 1999 and subsequent taxation years.

### Effect of Carryback of Loss, etc.

ITA
164(5)

Section 164 of the Act relates to tax refunds. Subsection 164(5) provides that, where the tax payable for a taxation year is reduced because of listed deductions or exclusions that relate to subsequent years, interest payable to a taxpayer on any resulting overpayment of tax is to be calculated as if the overpayment had arisen on the latest of several dates.

These amendments add to the list of deductions and exclusions: a deduction under new section 119 of the Act in respect of a disposition of taxable Canadian property by a taxpayer in a subsequent taxation year; a deduction under new subsection 126(2.21) or (2.22) in respect of foreign taxes paid for a subsequent taxation year; and deductions under new subsections 128.1(6) to (8) of the Act in respect of an election in a subsequent taxation year.

These amendments apply to taxation years that end after October 1, 1996.

### Interest – Disputed Amounts

ITA
164(5.1)

Subsection 164(5) of the Act provides that, where the tax payable for a taxation year is reduced because of certain deductions or exclusions arising from tax credits, the carryback of losses, or events in subsequent years, interest payable to a taxpayer on any resulting overpayment of tax is to be calculated as if the overpayment had arisen on the latest of several dates. Subsection 164(5.1) of the Act, which deals with the calculation of interest on repayments of amounts in dispute, parallels the rules contained in subsection 164(5).

Subsection 164(5.1) is amended to simplify its structure and to accommodate the new deductions listed in the commentary on subsection 164(5), above.

This amendment applies to taxation years that end after October 1, 1996.

## Realization of Deceased Employees' Options

ITA
164(6.1)

Subsection 164(6.1) of the Act applies to certain employee stock options in respect of which a benefit has been included in a deceased taxpayer's income by reason of subparagraph 7(1)(*e*) of the Act. This subsection applies where the employee stock option is exercised or disposed of by the deceased's legal representative in the first taxation year of the deceased's estate.

Subparagraph 164(6.1)(*a*)(iii) is amended by replacing the reference to the fraction "1/4" with a reference to the fraction "1/2". The change is consequential to the reduction in the capital gains inclusion rate from 3/4 to 1/2.

The amendment applies to deaths that occur after February 27, 2000 except that, for deaths that occur after February 27, 2000 and before October 18, 2000, the reference to the fraction "1/2" in subparagraph 164(6.1)(*a*)(iii) is to be read as a reference to "1/3". These modifications are required in order to reflect the capital gains/losses rate for the year.

## Clause 157

## Objections to Assessments

ITA
165(2.1)

Subsection 165(2.1) of the Act provides that the extension of time to object to an assessment referred to in subsection 165(1) applies only in respect of assessments and determinations made under Parts I, I.1 and I.2. The amendment to subsection 165(2.1) is consequential to the repeal of the surtax imposed on individuals under Part I.1 of the Act (see commentary on that Part).

This amendment applies to the 2001 and subsequent taxation years.

## Clause 158

### Ecological Gifts

ITA
169(1.1)

New subsection 169(1.1) of the Act is added to provide a person with a right to appeal, within 90 days of the issue of a certificate by the Minister of the Environment under subsection 118.1(10.5), that Minister's redetermination or confirmation under subsection 118.1(10.4) of the fair market value of donated ecologically sensitive land.

This amendment generally applies to gifts made after February 27, 2000.

## Clause 159

### Ecological Gifts

ITA
171(1.1)

Section 171 of the Act provides the rules applicable to income tax appeals disposed of by the Tax Court of Canada. New subsection 171(1.1) adds rules applicable to appeals under new subsection 169(1.1) in respect of determinations of the fair market value of donated ecologically sensitive land.

This amendment applies to gifts made after February 27, 2000.

## Clauses 160 and 161

### Individual Surtax

ITA
Part I.1

Part I.1 of the Act imposes a 5 per-cent surtax on that portion of an individual's Part I tax in excess of $12,500. This surtax is repealed, effective for the 2001 and subsequent taxation years. For 2000, this surtax is equal to 5 per cent of the individual's Part I tax in excess of $15,500.

### Former Resident – Credit for Tax Paid

ITA
180.1(1.4)

New subsection 40(3.7) of the Act provides a "stop-loss" rule that may apply to reduce the loss of an individual from the disposition of property at a particular time, where the individual was non-resident at any time before the particular time and received dividends in respect of the property while non-resident. New section 119 of the Act provides a special tax credit in certain cases where subsection 40(3.7) applies to an individual who ceased to be resident in Canada. If an individual's Part I tax for the year that includes the emigration is less than the amount deductible under section 119, new subsection 180.1(1.4) of the Act provides that the individual may deduct the balance from the tax otherwise payable under Part I.1 of the Act for that year.

New subsection 180.1(1.4) applies after October 1, 1996.

### Meaning of Tax Payable Under Part I

ITA
180.1(2)(*a*) and (*b*)

Subsection 180.1(2) of the Act provides rules for calculating Part I tax for the purposes of determining the base for tax under Part I.1 of the Act ("surtax"). Essentially, the tax base for surtax is the individual's tax payable for the year under Part I of the Act, calculated without reference to certain amounts.

Paragraphs 180.1(2)(*a*) and (*b*) are amended to add to the list of those amounts an amount deductible under new section 119 of the Act in respect of a former resident of Canada.

These amendments apply after October 1, 1996.

## Clause 162

### Tax on Old Age Security Benefits

ITA
180.2(4)(*a*)(ii)

Section 180.2 of the Act provides for the recovery of Old Age Security (OAS) benefits paid to an individual to the extent that the individual's income for a year exceeds an indexed $50,000 threshold ($55,309 in 2001). In 1996, the structure of the recovery of OAS benefits was modified by providing for tax to be withheld on the benefits. Given that the amount of the benefits recovered is computed, in part, by reference to 15% of the individual's income in excess of $50,000 (or effectively 1.25% of the excess on a monthly basis), the formula in subsection 180.2(4) includes an amount of $625, which is equal to 1.25% of $50,000. However, because of the recovery of OAS benefits through withholding was introduced in 1996, at the time where the threshold was equal to $53,215, the amount used in the formula should have then be set at $665, i.e., 1.25% of $53,215. This amendment corrects this oversight.

This amendment applies after November 1999.

## Clause 163

### Large Corporations Tax

ITA
Part I.3

Part I.3 of the Act imposes a tax (generally known as the "large corporations tax" or LCT) on the amount by which a large corporation's taxable capital employed in Canada exceeds a $10 million "capital deduction" (shared among related corporations).

### Financial Institutions

ITA
181.3

Section 181.3 of the Act provides rules for determining the capital, taxable capital, taxable capital employed in Canada and investment allowance of a financial institution (as defined in subsection 181(1) of the Act) for the purposes of the LCT. The section is amended to include new rules, applicable after June 27, 1999, for determining the capital of an authorized foreign bank.

### Capital of Financial Institution

ITA
181.3(3)

Subsection 181.3(3) of the Act sets out the rules for calculating the capital of a financial institution for the purposes of Part I.3. This provision is amended to define a notional amount of capital for an authorized foreign bank.

Paragraph 181.3(3)(*a*) is amended to exclude authorized foreign banks from the general rule and new paragraph 181.3(3)(*e*) is added, to define the capital of an authorized foreign bank for a taxation year. This definition is based on the regulatory capital requirements that Canada's Office of the Superintendent of Financial Institutions (OSFI) applies to Canadian banks. Specifically, the capital of an authorized foreign bank for a year is the total of two amounts:

- Under new subparagraph 181.3(3)(*e*)(i), 10% of the bank's risk-weighted assets and exposures at the end of the year, in respect of its Canadian banking business, as those would be reported under OSFI's risk-weighting guidelines if the guidelines applied and required reporting at that time. For this purpose, the relevant OSFI guidelines are newly defined in subsection 248(1) of the Act to mean the guidelines issued under authority of section 600 of the Bank Act, as those guidelines stood on August 8, 2000.

- Under new subparagraph 181.3(3)(*e*)(ii), all amounts in respect of the business, at the end of the year, that would be deducted from the bank's capital, under OSFI's risk-based capital adequacy guidelines, in determining the adequacy of the bank's capital if the bank were a bank listed in Schedule II to the *Bank Act*. These amounts, which include goodwill that is recorded on the bank's balance sheet, unconsolidated investments in subsidiaries, and other substantial investments, generally carry a risk-weighting of zero, and so will not figure in the bank's capital for LCT purposes under subparagraph (*e*)(i). On the other hand, certain securitized assets, loss facilities in connection with which would be deducted from a Schedule II bank's capital, are nonetheless included in a foreign bank's risk-weighted assets pool at ratings greater that zero: to avoid counting these assets twice for LCT purposes, new clause (*e*)(ii)(B) excludes from the subparagraph (ii) amount any amount in respect of a loss protection facility that OSFI's asset securitization guidelines require to be deducted from capital.

These amendments apply after June 27, 1999.

## Investment Allowance of Financial Institution

ITA
181.3(4)

Subsection 181.3(4) of the Act defines the investment allowance of a financial institution for a taxation year for the purposes of Part I.3. Paragraphs (4)(*a*) and (*b*) are amended to refer to an "eligible investment", a term defined in new subsection 181.3(5), which incorporates conditions previously contained in the text of these paragraphs, as well as a new residency condition.

New paragraph 181.3(4)(*c*) defines the investment allowance of an authorized foreign bank. Like other financial institutions, an authorized foreign bank's taxable capital for a taxation year is the amount, if any, by which its capital for the year exceeds its investment allowance for the year. Its investment allowance for a taxation year is essentially the full (i.e. not risk-weighted) year-end amount of its "eligible investments" used or held in its Canada banking business as those would be required to be reported under the OSFI risk-weighting guidelines (defined in subsection 248(1)) if the guidelines were applicable.

This amendment applies after June 27, 1999.

### Interpretation

ITA
181.3(5)

Amended subsection 181.3(5) of the Act defines an "eligible investment" of a financial institution for the purpose of determining its investment allowance under subsection 181.3(4) of the Act. The main conditions, previously set out directly in subsection 181.3(4), are that the investment be a share or long-term debt of a related financial institution that is not exempt from tax. A new requirement is introduced that the investee corporation be either resident in Canada or use the proceeds of the share or debt in a business carried on through a permanent establishment in Canada. It is proposed that the definition of permanent establishment for this purpose be that set out in section 8201 of the *Income Tax Regulations*. New paragraph 181.3(5)(*b*) sets out an interpretive rule relating to credit unions that was previously contained in subsection 181.3(4) of the Act.

New subsection 181.3(5) generally applies after June 27, 1999 except that the coming-into-force of the requirement in subparagraph (5)(*a*)(iii) is deferred for taxpayers other than authorized foreign banks until the 2002 taxation year.

## Clause 164

### Part IV

### Interpretation

ITA
186(7)

Dividends received from a "connected corporation" are generally not subject to Part IV tax under section 186 of the Act. Subsection 186(4) and subsection 186(2) set out the circumstances in which corporations are connected. Whether corporations are connected is also relevant for other purposes in the Act including the anti-dividend stripping rules in sections 84, 84.1 and 212.1 of the Act.

However, for the purposes of applying section 84.1, the Tax Court of Canada found in the *Olsen* case ([2000] 3 C.T.C. 2299, 2000 D.T.C. 2121) that the meaning of the term "connected" in subsection 186(4) is to be determined without reference to subsection 186(2). If this decision is correct, its implications go beyond the application of the above-mentioned anti-dividend stripping rules. In particular, the finding could have adverse implications for taxpayers in the context of determining the application of certain definitions that could benefit taxpayers, including the definition "small business corporation" in subsection 248(1) and the definition "qualified small business corporation share" in subsection 110.6(1) of the Act. The *Olsen* decision has been appealed to the Federal Court of Appeal.

New subsection 186(7) provides that, for greater certainty, the meaning of the term "connected" in subsection 186(4) is to be determined by taking into account the application of subsection 186(2). However, this is not the case where a provision, for example subparagraph 110.6(15)(b)(ii), expressly states that the term "connected" (within the meaning assigned by subsection 186(4)) is to be determined without reference to subsection 186(2).

Generally, this amendment applies on and after Announcement Date. However, if a taxpayer elects (and certain conditions are met), this amendment does not apply to actions or transactions of a taxpayer that are required to be carried out under an agreement in writing made by the taxpayer before Announcement Date. Such an election (including a copy of the agreement) must be filed with the Minister of National Revenue before the day that is 60 days after the day on which this Act receives Royal Assent.

## Clauses 165 to 167

### Financial Institutions Capital Tax

ITA
Part VI

Part VI of the Act taxes the amount by which a financial institution's taxable capital employed in Canada exceeds a capital deduction of up to $220 million (which is shared among related institutions). Part VI also applies additional taxes to life insurance corporations and deposit-taking institutions. Part VI is amended, with application after June 27, 1999, to include special rules for the taxation of authorized foreign banks.

### Additional Tax Payable by Life Insurance Corporations

ITA
190.1(1.1)

Subsection 190.1(1.1) of the Act imposes an additional temporary tax on the capital employed in Canada for a taxation year of a life insurer in excess of its capital allowance. The additional tax, which was first announced in the 1992 budget, was scheduled to expire on December 31, 1998. The description of C in the subsection is amended to extend the application of the additional tax for two further years – until December 31, 2000.

This amendment applies to taxation years that end after 1998.

### Capital

ITA
190.13

Section 190.13 of the Act defines the capital of a financial institution for a taxation year for the purposes of Part VI. The section is amended to include, in new paragraph 190.13(*d*), a special rule for authorized foreign banks. This new rule defines such a bank's capital for purposes of Part VI in the same way as new paragraph 181.3(3)(*e*) of the Act does for the purposes of the large corporations tax in Part I.3 of the Act. Readers may refer to the notes to that provision for more information.

This amendment applies after June 27, 1999.

### Investment in Related Institutions

ITA
190.14

Section 190.14 of the Act applies for the purpose of determining, under Part VI, the amount of a corporation's investment in related financial institutions. This amount is deductible from the corporation's capital, as determined under section 190.13 of the Act, in computing its taxable capital under section 190.12 of the Act.

Section 190.14 is amended by incorporating most of its content into a new subsection (1). Paragraphs (*a*) and (*b*) are amended to refer to an "eligible investment", a term defined in new subsection 190.14(2), which incorporates conditions previously contained in the text of these paragraphs, as well as a new residency condition.

New paragraph 190.14(1)(*c*) defines the investment allowance of an authorized foreign bank. The bank's investment in related institutions is essentially the full (i.e. not risk-weighted) year-end amount of its "eligible investments" used or held in its Canadian banking business as those would be reported under the OSFI risk-weighting guidelines (defined in subsection 248(1)) if the guidelines were applicable. The new provision clarifies that the relevant amount in respect of surplus contributed to an institution is the amount of such surplus contributed by the bank in the course of carrying on its Canadian banking business.

New subsection 190.14(2) of the Act defines an "eligible investment" of a corporation in a financial institution for the purpose of determining its investment allowance under subsection (1). The main conditions, previously set out directly in paragraphs 190.14(*a*) and (*b*) are that the investment be a share or long-term debt of, or surplus contributed to, a related financial institution. A new requirement is introduced in new paragraph 190.14(2)(*b*) that the investee financial institution be either resident in Canada or use the surplus or the proceeds of the share or debt in a business carried on through a permanent establishment in Canada. It is proposed that the definition of permanent establishment for this purpose be that set out in section 8201 of the *Income Tax Regulations*.

These amendments generally apply after June 27, 1999 except that the coming-into-force of the requirement in subsection 190.14(2)(*b*) is deferred for taxpayers other than authorized foreign banks until the 2002 taxation year.

## Clause 168

## Deferred Profit Sharing Plans and Revoked Plans

ITA
204

Section 204 of the Act provides rules relating to deferred profit sharing plans (DPSPs) and revoked plans.

### Definitions

"qualified investment"

The definition "qualified investment" in section 204 of the Act is relevant directly to deferred profit sharing plans (DPSPs), and indirectly to other tax-deferred registered plans such as registered retirement savings plans (RRSPs).

The definition is amended in four respects. First, the definition is modified (with effect after June 27, 1999) to include money denominated in any currency, whether Canadian or foreign. An exception excludes currency held as a collectible or as a commodity: that is, money the fair market value of which exceeds its stated value as legal tender in its country of issue or that is held for its numismatic value.

Second, deposits with a Canadian branch of an authorized foreign bank will, after June 27, 1999, be qualified investments.

Third, after 2002, the only deposits that will be qualified investments will be those that are either deposits within the meaning of the *Canada Deposit Insurance Act*, or deposits with bank branches in Canada. As a result, bank deposits that are excluded from the *Canada Deposit Insurance Act* definition because they are repayable outside Canada will not be qualified investments if they are made with a branch outside Canada.

Fourth, paragraph (*c*) of the definition is amended to provide that a bond, debenture, note or similar obligation issued by an authorized foreign bank and payable at a branch in Canada of that bank will be a qualified investment for such a trust after June 27, 1999.

## Clause 169

### Tax in Respect of Certain Property Acquired by Trusts, etc.

ITA
Part XI

Part XI of the Act sets out the rules for the 1% per month penalty tax on deferred income plans and funds, master trusts and registered investments listed in section 205 in respect of their excess foreign property holdings.

### Definitions

ITA
206(1)

"cost amount"

Part XI of the Act provides a foreign property limit for certain taxpayers, mainly tax-exempt taxpayers such as trusts governed by registered retirement savings plans and registered pension plans. In general, a penalty tax is applied under subsection 206(2) where the total cost amount of foreign property in such a trust or plan exceeds a specified percentage of the total cost amount of all property in the trust or plan.

Where such a taxpayer holds a capital interest in a trust, the income of the trust is usually made payable to the taxpayer so that the income is not taxed at the trust level. Arrangements have been made, however, to "capitalize" income and other amounts payable without the trust issuing new units or otherwise making a payment in satisfaction of the amounts. These arrangements are designed to maximize the indirect foreign property holdings for these unitholders by minimizing the cost amount with regard to these capital interests.

Subsection 206(1) is amended to add a special definition of "cost amount" for the purposes of Part XI. The definition is designed to increase the cost amount of a taxpayer's interest in a trust to reflect capitalized amounts payable to the taxpayer. It is also intended to amend Part L of the *Income Tax Regulations* to make it clear that the definition also applies for this purpose. See Appendix E for additional commentary.

This amendment applies to months that end after February 2001.

"foreign property"

Subsection 206(1) of the Act contains the definition "foreign property". Paragraph (*g*) of this definition treats as foreign property the indebtedness of a non-resident person other than a prescribed person or any of various international organizations. The paragraph is amended so that indebtedness issued by and payable at a Canadian branch of an authorized foreign bank is not foreign property. The amended definition applies after June 27, 1999.

## Acquisition of Qualifying Security

ITA
206(3.1) and (3.2)

Subparagraph 206(2)(*a*)(iii) of the Act provides relief from the imposition of the foreign property penalty tax in respect of property that was not foreign property when it was acquired, but that subsequently becomes foreign property, by not treating such property as foreign property for up to 24 months. Subsection 206(3.1) extends the relief provided by that subparagraph where a security that is foreign property is issued to a taxpayer in exchange for another security in the course of a change in control of the corporation that issued the other security or a corporate merger or reorganization of capital. In these circumstances, the new security is likewise not treated as foreign property for up to 24 months if the other security was not foreign property.

Section 206 is amended so that the existing rule in subsection 206(3.1) is reflected in amended subsection 206(3.1) and new subsection 206(3.2).

New subsection 206(3.2) extends the relief provided by subparagraph 206(2)(*a*)(iii) to include the circumstances where a new security is issued to a taxpayer in exchange for another security in the course of a transaction or series of transactions in which all or substantially all of the issued and outstanding shares of a corporation (other than shares held by a particular person or related group) that issued the other security are acquired by the particular person or related group. This relief applies where the shares of a corporation acquired by the particular person or related group in the course of the transaction or series represent a minority interest in the corporation.

Subsection 206(3.2) also ensures that the relief provided by subparagraph 206(2)(*a*)(iii) is available to a taxpayer where a particular security of the taxpayer that became foreign property in circumstances to which that subparagraph applied is, during the period of up to 24 months applicable to the particular security, subject to an "eligible distribution" (as defined in new section 86.1). In these circumstances, the new security (in new section 86.1 referred to as a "spin-off share") acquired by the taxpayer is deemed under subsection 206(3.1) to have been last acquired by the taxpayer at the time the particular security was last acquired by the taxpayer and to have become foreign property at the time the particular security became foreign property. This is intended to ensure that the remaining portion of that period of up to 24 months available in respect of the particular security applies after the eligible distribution to both the particular security and the new security. For more detail on eligible distributions, see the commentary to new section 86.1.

These amendments apply to months that end after 1997.

ITA
206(4)

Subsection 206(4) of the Act provides, for the purposes of Part XI, that property acquired by a taxpayer from a person with whom the taxpayer does not deal at arm's length and for less than fair market value consideration is treated as having been acquired at its fair market value at the time of its acquisition. For these purposes, trusts that have the same beneficiary are considered not to deal with each other at arm's length.

Subsection 206(4) is amended so that it does not apply to a transfer of property to which paragraph (*f*) or (*g*) of the definition "disposition" in subsection 248(1) applies. This amendment is intended to ensure that where a transfer of property is one to which either of those paragraphs applies and that involves a taxpayer to which subsection 206(4) would otherwise apply, the transfer will occur on a rollover basis.

This amendment applies in respect of property acquired after December 23, 1998.

This amendment is part of a set of amendments intended to clarify the tax treatment of transfers of property involving RRSPs and RRIFs. For further detail, see the commentary to paragraphs 107.4(2)(*b*) and (3)(*c*) and paragraphs (*f*) and (*g*) of the new definition "disposition" in subsection 248(1).

## Clause 170

### Tax Payable by Recipient of an Ecological Gift

ITA
207.31

Section 207.31 of the Act imposes a tax on charities and Canadian municipalities where they dispose of or change the use of property donated to them as an ecological gift without the approval of the Minister of the Environment. The tax is equal to 50% of the fair market value of the property at the time of the disposition or change in use. The section is amended to clarify that the fair market value will be that amount that would be determined at that time for a donor for the purposes of section 110.1 or 118.1 of the Act, as the case may be.

Amended section 207.31 applies where a charity or municipality disposes of or changes the use of an ecological gift after November 1999.

## Clauses 171 and 172

## Tax on Designated Income of Certain Trusts

ITA
Part XII.2

Part XII.2 of the Act imposes a special tax on certain trusts resident in Canada with respect to distributions to certain beneficiaries, including non-resident beneficiaries.

ITA
210.1(*d*)

Section 210.1 of the Act provides a list of trusts to which Part XII.2 does not apply.

Paragraph 210.1(*d*) is amended to add to the list of exempt trusts a trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1). This change is consequential to the introduction of paragraph (*a*.1) of that definition. For further detail on the amended definition "trust" in subsection 108(1), see the commentary on that provision.

This amendment applies to the 1999 and subsequent taxation years.

ITA
210.2(2)(*b*)

The tax under Part XII.2 of the Act is calculated with reference to a trust's "designated income" (as determined under subsection 210.2(2)). "Designated income" is calculated with reference to taxable capital gains and allowable capital losses from dispositions of the trust's taxable Canadian property, determined on the assumption that the trust is non-resident.

Paragraph 210.2(2)(*b*) is amended to remove the assumption described above. The amendment simplifies paragraph 210.2(2)(*b*) and does not represent any policy change.

This amendment applies after October 1, 1996.

## Clause 173

### Taxation of Non-Residents

ITA
212

Section 212 of the Act imposes taxes on certain amounts paid or credited to non-residents by residents of Canada. Pursuant to section 215 of the Act, the payer must withhold this tax. As well, section 212 contains rules of interpretation and related provisions.

### Non-Resident Withholding Tax – Interest

ITA
212(1)(*b*)(ii)(C)(IV)

Clause 212(1)(*b*)(ii)(C) of the Act provides an exemption from non-resident withholding tax for interest paid on certain government and government-guaranteed debt obligations, as well as debt obligations issued by entities used to be described in paragraph 149(1)(*d*), before that paragraph was amended and paragraphs 149(1)(*d.1*) to (*d*.6) were added, effective for taxation years and fiscal periods that begin after 1998. Clause 212(1)(*b*)(ii)(C) is, therefore, amended to refer to paragraphs 149(1)(*d*) to (*d*.6) consequential to the 1998 amendment to subsection 149(1).

This amendment applies to amounts paid or credited after 1998.

## Non-Resident Withholding Tax – Trust Distributions

ITA
212(1)(*c*)(i)

Paragraph 212(1)(*c*) of the Act generally provides that a non-resident beneficiary is subject to Part XIII withholding tax on trust distributions in connection with the same types of amounts on which a beneficiary resident in Canada is subject to tax under Part I.

Paragraph 212(1)(*c*) is amended to clarify that the tax consequences of a beneficiary's residence outside Canada will be taken into account in determining the amount subject to tax under paragraph 212(1)(*c*). These tax consequences include the potential indirect tax consequences to a beneficiary of a trust under subsection 104(13) or the application of subsection 107(5) to the trust because the beneficiary is non-resident.

This amendment, which is linked with new section 250.1, applies to amounts paid or credited after December 17, 1999.

## Acting Services

ITA
212(5.1)

New subsection 212(5.1) of the Act imposes a tax of 23% on the gross amount paid, credited or provided as a benefit to a non-resident person (either an individual non-resident actor or a corporation related to such an actor) in respect of film and video acting services provided by the non-resident person in Canada. In these notes, such payments are referred to as "acting services payments."

This new subsection and related amendments create a new system for the taxation of non-residents' acting services payments. This new system applies to acting services payments made after 2000.

The following are the main features of the new system:

Unless the recipient chooses to have acting services payments taxed under Part I of the Act (an option described more fully below), the recipient is liable to the tax under new subsection 212(5.1) – that is, a tax of 23% on the gross amount of the payments.

Whether or not the recipient chooses taxation under Part I, any person – including a non-resident – who makes an acting services payment must withhold and remit to the Receiver General 23% of the payment. (Amended subsection 215(1) of the Act.)

The recipient can choose to have ordinary income tax under Part I apply to all the acting services payments made to the recipient in a particular taxation year. To make this choice, the recipient must file a Part I tax return on or before the recipient's filing-due date for the year. The 23% amounts withheld and remitted are then treated as having been paid on account of the recipient's Part I tax liability. (New section 216.1 of the Act.)

If the recipient chooses Part I taxation of acting services payments, the payments are included as Canadian-source business or employment income, as the case may be, in computing the recipient's taxable income earned in Canada under section 115 of the Act. The recipient may thus apply the deductions and tax credits that are available to non-residents in respect of such income.

If the recipient does not choose taxation under Part I, no return need be filed (unless the recipient has other income subject to Part I tax), and the 23% withheld is the final amount of tax payable in respect of the acting services payment.

If the recipient is a corporation related to the actor, there may be two acting services payments: one to the corporation, and a second from the corporation to the actor. In this case, special rules apply.

If the corporation chooses to have the payment to it (the "corporation payment") taxed under Part I, the actor is treated as also having chosen to have the corporation's payment to the actor (the "actor payment") taxed under Part I. (New subsection 216.1(3) of the Act.)

If the corporation does not choose to have the corporation payment taxed under Part I, but instead treats the 23% withholding tax as final, the actor payment is not subject to the 23% withholding tax, except to the extent it exceeds the corporation payment. Note, however, that if the corporation makes the actor payment before the corporation's filing-due date, meaning that the corporation's choice is not known, the corporation is still required to withhold and remit the 23% from the actor payment. The amount withheld and remitted will be refundable to the actor (or applied against another liability of the actor) once the corporation's filing-due date has passed without the corporation having chosen Part I taxation. (New subsection 212(5.2) of the Act.)

If a corporation payment arising in one taxation year is taxed under subsection 212(5.1), and the corporation makes an actor payment in a subsequent taxation year, the actor payment is neither deductible in computing the corporation's income for any year nor included in computing the actor's taxable income earned in Canada for any year. (New subsection 115(2.2) of the Act.)

Where the 23% withholding would cause undue hardship, the Minister of National Revenue may agree that the payer of an acting services payment may withhold a lesser amount. (New subsection 212(5.3) of the Act.)

## Relief from Double Taxation

ITA
212(5.2)

New subsection 212(5.2) of the Act applies where an amount (the "corporation payment") is paid, credited or provided to a corporation related to a non-resident actor on account of acting services provided by the actor in Canada, and the corporation then pays, credits or provides an amount (the "actor payment") to the actor in respect of those same services. In such a case, the actor payment is not subject to the 23% tax under new subsection 212(5.1) except to the extent that the actor payment is greater than the corporation payment. This subsection avoids applying the new withholding tax twice to the same amount.

This new subsection applies to amounts paid, credited or provided after 2000.

### Reduction of Withholding

ITA
212(5.3)

New subsection 212(5.3) of the Act gives the Minister of National Revenue the authority, in a case where the Minister determines that undue hardship would otherwise occur, to reduce the amount of withholding required by new subsection 212(5.1). This is similar to the authority given to the Minister to reduce withholding on account of undue hardship for amounts subject to withholding under section 153 of the Act.

New subsection 212(5.1) applies to amounts paid, credited or provided after 2000.

### Deeming Rule for Partnerships

ITA
212(13.1)(*a*.1)

Subsection 212(13.1) of the Act contains rules applicable to Part XIII with respect to partnerships.

New paragraph 212(13.1)(*a*.1) deems a partnership to be a person if a partnership pays, credits or provides an amount described in subsection (5.1) to a non-resident actor, or to a corporation related to the non-resident actor. This ensures that the amount paid, credited or provided by the partnership is subject to withholding as required by new subsection 212(5.1) and amended subsection 215(1) of the Act.

New paragraph 212(13.1)(*a*.1) applies to amounts paid, credited or provided after 2000.

### Application of Part XIII to Authorized Foreign Bank

ITA
212(13.3)

Section 212 of the Act imposes a tax of 25% (reduced by many treaties) on certain amounts paid or credited to non-residents by residents of Canada. Pursuant to section 215 of the Act, this tax must be withheld by the resident payer.

New subsection 212(13.3) of the Act provides special rules regarding the application of withholding taxes under Part XIII of the Act to authorized foreign banks. This new subsection treats an authorized foreign bank as being resident in Canada for the purposes of any amount paid or credited to or by the bank with respect to its Canadian banking business. An authorized foreign bank is also deemed to be resident in Canada with respect to the application of the definition of Canadian partnership to paragraph 212(13.1)(*b*) of the Act, with respect to a partnership interest held by the bank in the course of its Canadian banking business.

As a result of this amendment, an authorized foreign bank will not pay tax under section 212 on, for example, interest payments its Canadian banking business receives from residents of Canada. On the other hand, the bank will be responsible for withholding the tax payable by a non-resident to whom it makes a taxable payment.

This new subsection applies after June 27, 1999.

## Clause 174

### Deduction and Payment of Tax

ITA
215(1)

Subsection 215(1) provides that, where a resident of Canada pays or is deemed to pay an amount to a non-resident in respect of which the non-resident is liable for withholding tax under Part XIII of the Act, the payer is required to withhold the tax from the amount and remit it to the Receiver General on behalf of the non-resident.

Subsection 215 is amended to ensure that withholding and remittance occur on all amounts paid, credited or provided to a non-resident, even those that may not be subject to tax under Part XIII because a non-resident provider of acting services makes an election under new subsection 216.1 to file a Part I return. (If that election is made, the amount withheld under Part XIII is treated as tax paid on account of any Part I tax owing.

This amendment applies to amounts paid, credited or provided after 2000.

### Regulations Reducing Deduction or Withholding

ITA
215(5)

Subsection 215(5) of the Act provides that the Governor in Council may make regulations reducing the tax to be withheld from certain payments made to a non-resident. The amendment to that subsection deletes a reference to paragraph 212(1)(*f*), which has been previously repealed.

This amendment applies to amounts paid or credited after April 1997, which is the time at which the repeal of paragraph 212(1)(*f*) came into force.

## Clause 175

### Alternative re Acting Services

ITA
216.1

New subsection 216.1(1) of the Act allows a non-resident who receives income from the provision of acting services to elect not to be taxed under new subsection 212(5.1) of the Act on that income. Instead, a non-resident who elects under this new section must include this income in computing the non-resident's taxable income earned in Canada under section 115 of the Act (or taxable income, if the non-resident was resident in Canada for part of the year). This income is then subject to tax at ordinary rates under Part I, instead of the flat 23% rate under new subsection 212(5.1).

New subsection 216.1(2) deems amounts withheld under new subsection 212(5.1) and remitted to be on account of Part I tax if the non-resident elects to file a return under subsection 216.1(1).

New subsection 216.1(3) applies to non-resident actors who use a related corporation to provide their acting services in Canada. In this situation, if the corporation has elected to be taxed under Part I of the Act in respect of a corporation payment, the actor is deemed to have made the same election in respect of the actor payment that relates to the corporation payment. The terms "corporation payment" and "actor payment" are defined in new subsection 212(5.2).

New subsection 216.1 applies to the 2001 and subsequent taxation years.

## Clause 176

### Additional Tax on Authorized Foreign Banks

ITA
Part XIII.1

New Part XIII.1 of the Act applies a special branch interest tax, in lieu of Part XIII withholding tax, to certain notional interest payments by an "authorized foreign bank." The operation of this new tax is tied to the special interest-deductibility rules that apply to such banks.

In general terms, new section 20.2 of the Act allows an authorized foreign bank to deduct on account of the interest expense of its Canadian banking business for a year one or more of three amounts:

1. Interest expense actually incurred by the bank in the year, in relation to liabilities of the Canadian banking business to other persons or partnerships;

2. Interest expense notionally incurred by the Canadian banking business in the year, in relation to documented "branch advances" from the bank itself to the business; and

3. A residual amount, representing interest for the year on the amount by which 95% of the value of the Canadian banking business's assets exceeds the total of its actual liabilities and its branch advances.

Existing Part XIII of the Act applies withholding tax to certain payments of interest by persons resident in Canada to non-residents. An amendment to Part XIII (new subsection 212(13.3)) treats an authorized foreign bank, in respect of its Canadian banking business, as being resident in Canada for purposes of that Part. As a result, the bank's actual interest payments to non-residents (item 1 above) may attract tax under Part XIII.

New Part XIII.1 complements Part XIII by ensuring the appropriate tax results in respect of an authorized foreign bank's notional and residual interest expenses (items 2 and 3 above). Specifically, new subsection 218.2(1) of the Act imposes a tax equal to 25% (the statutory rate under Part XIII) of an authorized foreign bank's "taxable interest expense" for a year. "Taxable interest expense" for a year is defined in new subsection 218.2(2) of the Act as 15% of the amount by which the bank's interest expense deduction for the year exceeds that part of the deduction that relates to actual liabilities to other persons or partnerships.

Canada's tax treaties have important effects on the taxation of non-residents' Canadian-source income. New Part XIII.1 includes two rules that reflect the influence of tax treaties. First, new subsection 218.2(3) of the Act states that an authorized foreign bank that is resident in a country with which Canada has a tax treaty is exempt from this tax, provided that a Canadian-resident bank that carried on business in that country would not be required to pay a comparable tax. Thus an authorized foreign bank from a treaty country, which country either has no such tax or considers that its tax treaty with Canada precludes it from applying the tax to residents of Canada, is not liable to pay tax under new Part XIII.1.

Second, new subsection 218.2(4) of the Act limits the rate of tax under Part XIII.1 (otherwise 25%) where a tax treaty applies. If the relevant treaty includes a specific rate limit for the Part, that limit governs; if it does not, the applicable rate is the maximum rate that the treaty allows Canada to apply to interest payments between a resident of Canada and a related person in the treaty country.

New Part XIII.1 of the Act applies for taxation years that end after June 27, 1999.

## Clause 177

### Additional Tax

ITA
219

Section 219 of the Act imposes what is commonly known as the "branch tax" on non-resident corporations that carry on business in Canada.

ITA
219(1)(*b*)

Subsection 219(1) imposes liability to branch tax and describes the tax base. Paragraph 219(1)(*b*) includes in the base the amount of any dividends deducted because of section 112 and paragraph 115(1)(*d*.1) in computing the corporation's base amount. This amendment changes the reference from paragraph 115(1)(*d*.1) to 115(1)(*e*) as a consequence of an amendment to subsection 115(1). This amendment applies to the 1998 and subsequent taxation years.

### Income Inclusion

ITA
219(1)(*d*)

Paragraph 219(1)(*d*) of the Act adds to the branch tax base the non-taxable portion of any net gain realized by a non-resident corporation on the disposition of taxable Canadian property used in a Canadian business. Paragraph 219(1)(*d*) is amended to delete the reference to "1/3 of". The amendment is consequential to the reduction of the inclusion rate for capital gains from 3/4 to 1/2.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxpayer's taxation year that ends after February 27, 2000 but before October 17, 2000, the reference to the expression "the amount" in that paragraph is to be read as a reference to "1/2 of the amount".

## Excluded Gains

ITA
219(1.1)

Under subsection 219(1) of the Act, a non-resident corporation's taxable income earned in Canada for a taxation year is one of the elements of the corporation's tax base in respect of the "branch tax" imposed under Part XIV of the Act. Subsection 219(1.1) restricts the definition of taxable Canadian property for the purposes of computing a non-resident corporation's branch tax base under subsection 219(1). For those purposes, subsection 219(1.1) directs that the existing definition of taxable Canadian property in paragraph 115(1)(*b*) of the Act is to be read without reference to subparagraphs 115(1)(*b*)(i) and (iii) to (xii). As a consequence of the relocation of the definition "taxable Canadian property" to subsection 248(1) of the Act, it is now necessary to amend subsection 219(1.1) to reflect the new definition of taxable Canadian property.

This amendment applies after October 1, 1996.

## Exempt Corporations

ITA
219(2)(*a*)

Paragraph 219(2)(*a*) of the Act currently exempts banks from the branch tax. In recent years, non-resident banks have not been permitted to operate branches in Canada in any event, so the exemption has had no practical effect. With changes to the regulatory rules, however, "authorized foreign banks" may now open Canadian branches. Since part of the appropriate tax treatment of these banks is the application to them of the branch tax, paragraph 219(2)(*a*) is repealed.

This amendment applies for taxation years that end on or after June 28, 1999 – the date on which the relevant *Bank Act* amendments were proclaimed.

Given the extension of the branch tax to authorized foreign banks, it is proposed that the *Income Tax Regulations* be amended to set out, in new subsection 808(8), how the investment allowance of an authorized foreign bank for the purpose of paragraph 219(1)(*j*) of the Act is calculated.

## Clause 178

### Administration and Enforcement

ITA
220

Section 220 of the Act sets out a number of rules relating to the administration and enforcement of the Act.

### Security for Departure Tax

ITA
220(4.5) to (4.54)

New subsections 220(4.5) to (4.54) of the Act permit an individual to elect, on giving security acceptable to the Minister of National Revenue, to defer payment of an amount of tax that is owing as a result of the deemed disposition of a particular property (other than an employee benefit plan right) in paragraph 128.1(4)(*b*) of the Act. If such an election is made, interest does not start to accrue on the amount secured until such time as the amount becomes unsecured, as described below. In addition, relief is provided from a penalty under the Act to the extent that it is computed with reference to the unpaid tax with respect to the amount secured.

ITA
220(4.5)

New subsection 220(4.5) of the Act allows an individual to elect, in prescribed manner, to defer payment of an amount of tax that is owing as a result of the deemed disposition of a particular property in paragraph 128.1(4)(*b*) of the Act. It is intended that this deferral also operate in respect of the corresponding provincial taxes for which the Government of Canada has assessment and collection responsibilities, with the settlement of accounts between the governments taking place as the tax is collected. To understand how the subsection works, several points should be noted.

- The security rule is in a mechanical sense applied annually. That is, the Minister of National Revenue's obligation to accept security applies for one year at a time. This does not mean that the emigrant must file a renewed election each year, but only that the Minister will determine on an annual basis whether, and in what amount, the security may remain in place.

- While the election to provide security must ordinarily be made – and the security itself must be provided – on or before the individual's balance-due day for the year of emigration, special accommodation is provided for those who cease to be resident before these amendments receive Royal Assent. Those individuals have until their filing-due date for the taxation year that includes Royal Assent to make the election and provide the security.

- The provision requires the Minister of National Revenue to accept "adequate security." The adequacy of any particular proposal for security is a matter of fact. It is understood, however, that in respect of tax on a gain from the deemed disposition of shares of a corporation, the Minister will not exclude the possibility of accepting some or all of the shares as security.

Where an individual has elected under subsection 220(4.5) and has provided adequate security, the Minister of National Revenue must, for a particular taxation year that begins after the individual ceases to be a resident of Canada, accept adequate security for the lesser of two amounts. The amounts are, in effect:

(i) the individual's taxes under Parts I and I.1 of the Act for the emigration year, to the extent those taxes are attributable to the deemed disposition under paragraph 128.1(4)(*b*) of the Act of properties that have not been disposed of before the particular year and to be extent that those taxes have not been deemed under the Act or any other Act to have been paid; and

(ii) if the particular year does not immediately follow the emigration year, the amount for which security was accepted for the preceding taxation year.

Where an individual who emigrated from Canada actually disposes, in a given year, of a property that was the subject of a deemed disposition on emigration, the Minister's obligation to accept security for the tax attributable to the deemed disposition of that property lasts only until the individual's balance-due day for the given year. The amount for which the Minister must accept security, in respect of a given departure from Canada, may thus decrease from year to year as the former emigrant disposes of properties. The amount cannot, however, increase.

An amount of tax may also become unsecured if the security furnished by the taxpayer for the tax has ceased to be adequate. For additional information in respect of inadequate security, see the commentary on subsection 220(4.53).

The effects of the acceptance of security by the Minister under subsection 220(4.5) are, first, that the Minister will not take any action to collect the tax so secured, and second, that for the purpose of computing interest and penalties owing by the taxpayer, the amount secured will be treated as an amount paid on account of the tax liability.

New subsection 220(4.5) generally applies to dispositions that occur after October 1, 1996. However, as noted above, elections made and security furnished under this subsection will be considered timely if effected before the taxpayer's filing-due date for the taxation year that includes the particular day on which these amendments receive Royal Assent.

**Deemed Security**

ITA
220(4.51)

New subsection 220(4.5) of the Act permits an individual to elect, on giving adequate security to the Minister of National Revenue, to defer payment of an amount of tax that is owing as a result of the deemed disposition of a particular property in paragraph 128.1(4)(*b*) of the Act. New subsection 220(4.51) treats an individual (other than a trust) as having furnished acceptable security to the Minister for the lesser of two amounts. The first amount is the total amount of taxes under Parts I and I.1 of the Act that would be payable, at the highest tax rate that applies to individuals, on a taxable capital gain of $50,000. (For administrative simplicity, this amount is described in the provision as the amount of those taxes that an *inter vivos* trust would pay for a year if the trust's taxable income for the year were $50,000.)

The second amount is the greatest amount of tax for which the Minister is required to accept security under subsection 220(4.5) for any particular taxation year of the individual. The deemed security is treated as having been furnished by the individual before the individual's balance-due day for the year in which the individual ceased to be a resident of Canada.

The effect of this provision is to excuse individual emigrants (other than trusts) from the requirement to provide security for an amount at least equal to the taxes payable on their first $100,000 of capital gains ($50,000 of taxable capital gains) resulting from the deemed disposition on emigration.

New subsection 220(4.51) applies after October 1, 1996. To reflect recent charges to the inclusion rate for capital gains, a transitional rule provides that the amount "$50,000" in new paragraph 220(4.52)(*a*) is to be read as a reference to "$75,000" in respect of emigration years that are before 2001.

**Limit**

ITA
220(4.52)

New subsections 220(4.5) and (4.51) of the Act set out rules respecting the posting of security for tax that is owing as a result of a deemed disposition of property under paragraph 128.1(4)(*b*) of the Act. New subsection 220(4.52) of the Act limits the amount of tax that may be so secured to the total tax payable under Parts I and I.1 of the Act in respect of the application of paragraph 128.1(4)(*b*) in the taxation year that the individual ceased to be a resident of Canada (calculated without reference to any of the deductions or exclusions listed in paragraph 161(7)(*a*) of the Act).

New subsection 220(4.52) applies after October 1, 1996.

## Inadequate Security

ITA
220(4.53)

New subsection 220(4.5) of the Act permits an individual to elect, on giving security acceptable to the Minister of National Revenue, to defer payment of an amount of tax that is owing as a result of the deemed disposition of a particular property in paragraph 128.1(4)(*b*) of the Act. If such an election is made, interest and penalties do not accrue on the particular amount secured until such time as the amount becomes unsecured.

If the Minister determines, at any time, that the security accepted under subsection 220(4.5) is not adequate to secure the particular amount for which it was furnished by the individual, new subsection 220(4.53) of the Act provides that the security secures the part of the particular amount for which it is adequate security at that particular time; the balance of the particular amount is unsecured. The Minister is required to notify the individual in writing if part of the particular amount becomes unsecured in this manner, and the individual has the opportunity to furnish further security to the Minister within 90 days of being so notified. Where additional security is so furnished, the Minister is deemed to have accepted it in accordance with subsection 220(4.5).

New subsection 220(4.53) applies after October 1, 1996.

## Extension of Time

ITA
220(4.54)

New subsection 220(4.5) of the Act permits an individual to elect, on giving security acceptable to the Minister of National Revenue, to defer payment of an amount of tax that is owing as a result of the deemed disposition of a particular property in paragraph 128.1(4)(*b*) of the Act. This election must be made, and the security furnished, on or before the balance-due date for the taxation year that the individual ceased to be a resident of Canada. New subsection 220(4.53) of the Act permits an individual to furnish additional security to the Minister, where the Minister has notified the individual that security previously furnished is no longer adequate. The additional security must be so furnished within 90 days of the Minister's notification.

New subsection 220(4.54) of the Act permits the Minister to extend the time available to an individual to make an election or to furnish security under subsection 220(4.5), or to furnish additional security under subsection 220(4.53), where the Minister considers it just and equitable to do so.

New subsection 220(4.54) applies after October 1, 1996.

## Security for Trusts Distributing Taxable Canadian Property to Non-Resident Beneficiaries

ITA
220(4.6) to (4.63)

New subsections 220(4.6) to (4.63) of the Act permit a trust to elect, on the giving of security acceptable to the Minister of National Revenue, to defer payment of an amount of tax that it owes as a result of the distribution of a taxable Canadian property to a non-resident beneficiary. If such an election is made, interest does not start to accrue on the amount secured until such time as the amount becomes unsecured. In addition, relief is provided from a penalty under the Act to the extent that it is computed with reference to the unpaid tax with respect to the amount secured. These subsections are structured in a similar manner to new subsections 220(4.5) to (4.53), and are intended to operate similarly with respect to both federal and provincial taxes.

Subsection 220(4.6) applies where such a distribution is made and, only because of subsection 107(5) of the Act, the rollover under paragraphs 107(2)(*a*) to (*c*) of the Act does not apply to the distribution. Provided that the trust makes an election on or before the trust's balance-due day for the distribution year (or at a later time permitted under subsection 220(4.63)) and furnishes security before that balance-due day (or at a later time permitted under subsection 220(4.63)), the Minister is required to accept security in respect of each taxation year after the distribution year of an amount up to the amount specified under paragraph 220(4.6)(*c*) in respect of that subsequent year. The amount is required to be accepted until the balance-due day for that subsequent year.

The amount specified under paragraph 220(4.6)(*c*) for a particular taxation year of a trust is equal to the lesser of the following two amounts:

- the portion of the trust's total tax payable under Parts I and I.1 of the Act (determined without reference to loss carrybacks and other amounts specified under paragraph 161(7)(*a*)) for the distribution year that would not have been payable if each such distribution of taxable Canadian property (other than taxable Canadian property subsequently disposed of before the beginning of the particular year) had not occurred, to the extend that those taxes have not been deemed under the Act or any other Act to have been paid; and

- where the particular year does not immediately follow the distribution year, the amount so specified for the taxation year of the trust that immediately precedes the particular year.

The relief with regard to arrears interest and penalties is provided under new paragraph 220(4.6)(*d*). This provision provides that interest is generally payable as if the particular amount for which adequate security is accepted at any time under subsection 220(4.6) in a particular period ending on the balance-due day for a taxation year subsequent to the distribution year had actually been paid on account of the trust's taxes under Parts I and I.1 for the distribution year. The particular amount in respect of a period that ends on a trust's balance-due day for a subsequent taxation year cannot exceed the amount specified under paragraph 220(4.6)(*c*) for the year. In addition, the particular amount is constrained because of the limit under subsection 220(4.61). However, paragraph 220(4.6)(*d*) does not apply with respect to interest on unpaid tax instalments which is dealt with under new subsection 107(5.1) of the Act.

Subsection 220(4.61) limits the amount for which the Minister is considered to have accepted security under subsection 220(4.6), in order to take into account reductions as of any day, for the purpose of computing arrears interest, in the calculation of taxes under Parts I and I.1 arising from the carryback of losses and similar amounts. The effect of subsection 220(4.61) is to limit the amount of acceptable security as of any day in respect of a trust's tax payable for a distribution year to:

- the total taxes payable by the trust under those Parts for the distribution year, determined without reference to such reductions that occur after that day

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- the total taxes payable under those Parts, determined without reference to such reductions and as if the rollover rules in subsection 107(2) had applied to distributions in the distribution year not covered by those rules only because of subsection 107(5).

Subsection 220(4.62) provides rules which apply where security furnished by a trust under subsection 220(4.6) ceases to be adequate. These rules are essentially the same as the rules in subsection 220(4.53). As noted above, subsection 220(4.63) allows for the late filing of elections and the late furnishing of security. Subsection 220(4.63) is essentially the same as subsection 220(4.54).

These amendments apply to distributions that occur after October 1, 1996. However, transitional measures treat elections made, and security furnished, up to the taxpayer's filing-due date for the year in which these amendments receive Royal Assent as having been made at such time as to maximize the benefits under subsection 220(4.6).

### Undue Hardship

ITA
220(4.7) and (4.71)

In some circumstances, an individual who wishes to provide security under new subsection 220(4.5) or (4.6) of the Act may be unable to do so without undue hardship. In such a case, new subsection 220(4.7) of the Act authorizes the Minister of National Revenue to accept security different from, or of lesser value than, that which would otherwise be required. The Minister is under no obligation to exercise this discretion, and can in any event do so only if the individual can without undue hardship neither provide security, pay the tax owing, nor reasonably arrange to have the security provided or the tax paid on the individual's behalf.

New subsection 220(4.71) of the Act provides that in making a determination under subsection 220(4.7), the Minister will ignore any transaction by which a person or partnership limits their rights in respect of a property, if the transaction can reasonably be considered to have been entered into in order to influence the Minister's determination.

These new subsections apply to dispositions and trust distributions that occur after October 1, 1996.

## Clause 179

## Collection Restrictions

ITA
225.1

Section 225.1 of the Act imposes restrictions on the collection of tax where a taxpayer objects to or appeals from an assessment.

ITA
225.1(6)(*b*)

Subsection 225.1(6) provides for an exception to the collection restrictions in limited circumstances. Paragraph 225.1(6)(*b*) is amended to clarify that the collection restrictions, which do not apply in cases where source deductions were deducted from an employee's remuneration but not remitted to the Receiver General, also do not apply in cases where source deductions were required to be deducted or withheld but were not so deducted or withheld.

This amendment applies on Royal Assent.

## Clause 180

### Withholding Taxes

ITA
227

Section 227 of the Act provides special rules relating to source deductions and non-resident withholding tax under sections 153 and 215 respectively, and also deals with the application of certain Parts of the Act to particular persons and entities.

### Application to Crown

ITA
227(4.3)

New subsection 227(4.3) of the Act clarifies that the deemed trusts in subsections 227(4) and (4.1) relating to unremitted source deductions are binding on Her Majesty in right of Canada or of a province. Accordingly, the deemed trusts will always take priority over any other security interest in favour of the Crown, subject to prescribed security interests as provided in the *Income Tax Regulations*.

Subsection 227(4.3) applies on Royal Assent.

### Municipal or Provincial Corporation Excepted

ITA
227(16)

Subsection 227(16) of the Act deems municipal and provincial corporations, which are exempt from tax because of paragraph 149(1)(*d*), not to be private corporations for the purposes of the Part IV tax. This amendment extends this treatment to corporations that are exempt from tax under any of paragraphs 149(1)(*d*) to (*d*.6) and is consequential to the addition of paragraphs 149(1)(*d*.1) to (*d*.6) made applicable to taxation years and fiscal periods that begin after 1998.

This amendment applies to taxation years that begin after 1998.

## Clause 181

### Definitions

ITA
231

Section 231 of the Act provides definitions for the purposes of sections 231.1 to 231.6, the provisions that set out the rules relating to the powers of the Canada Customs and Revenue Agency to audit and examine taxpayers' books and records.

Section 231 is amended to provide that the section also applies to new section 231.7, which deals with compliance orders. For commentary on the new compliance orders, see the commentary on new section 231.7.

This amendment applies on Royal Assent.

## Clause 182

### Compliance

ITA
231.5(2)

Subsection 231.5(2) of the Act makes it an offence to hinder, molest or interfere with an official who is performing certain administrative and enforcement functions. This provision does not apply in the context of an official who is performing a collection duty, or to attempts to hinder, molest or interfere with an official.

Subsection 231.5(2) is amended to apply in respect of any act that the official is authorized under the Act to perform. The provision is also amended to prohibit a person from attempting to hinder, molest or interfere with an official who is performing any such act. This amendment applies after the enacting legislation receives Royal Assent.

## Clause 183

## Compliance Order

ITA
231.7

Sections 231.1 to 231.6 of the Act set out the rules relating to the powers of tax administrators to audit and examine taxpayers' books and records. In particular, section 231.1 authorizes the inspection, audit and examination of books, records and property, and section 231.2 provides that a person may be required, by notice, to provide information or documents relating to the administration or enforcement of the Act. If a person refuses to comply with section 231.1 or 231.2, the person is subject to criminal prosecution under section 238 of the Act.

New section 231.7 provides an alternative means of enforcing compliance with sections 231.1 and 231.2. Where a person has failed to comply, subsection 231.7(1) allows the Minister of National Revenue to seek, by way of summary application, a court order requiring the person to provide the access, assistance, information or document sought under section 231.1 or 231.2. Under subsection 231.7(2), the person must be given notice of the application at least five clear days before it is heard. Subsection 231.7(3) gives the judge hearing the application the discretion to impose such conditions on the order as the judge considers appropriate.

Subsection 231.7(4) provides that a person who refuses to comply with the judge's order may be found in contempt of court and will be subject to the processes and punishments of the court to which the judge is appointed.

Subsection 231.7(5) provides that an order made under this new provision may be appealed to the court that has appellate jurisdiction over the court to which the judge that made the order is appointed, but that the execution of the order is not suspended unless it is so ordered by the court to which the appeal is made.

New section 231.7 comes into force on Royal Assent.

## Clause 184

### Foreign Property Reporting – Definitions

ITA
233.3(1) "specified foreign property"

Section 233.3 of the Act establishes reporting requirements in respect of foreign property. Subsection 233.3(1) defines a number of terms for the purpose of the section. The definition "specified foreign property" is amended to add new paragraph (*o*.1), which excludes from the scope of the definition a right with respect to, or indebtedness of, an authorized foreign bank that is issued by, and payable or otherwise enforceable at, a branch in Canada of the bank.

This amendment applies after June 27, 1999.

## Clause 185

ITA
239(2.21)(*a*)

Paragraph 239(2.21)(*a*) of the Act provides that it is an offence for a person to whom tax information has been provided for certain authorized purposes to knowingly make or allow unauthorized use of the information. The commission of this offence is punishable on summary conviction by a fine of up to $5,000 or imprisonment for a term not exceeding 12 months, or both. Paragraph 239(2.21)(*a*) is amended consequential to the amendment of subsection 241(4) which is discussed below in the note accompanying changes to that provision. This change applies after Royal Assent.

## Clause 186

### Provision of information

ITA
241

Section 241 of the Act prohibits the use or communication by an official of taxpayer information obtained under the Act unless specifically authorized by one of the exceptions found in that section.

### Provision of Information – Registered Charities

ITA
241(3.2)

Subsection 241(3.2) of the Act permits the Canada Customs and Revenue Agency to release specified information relating to an organization that was at any time a registered charity under the Act. The amendment clarifies that specified information may be released at a time when the organization is no longer a registered charity, provided that the information to be released relates to a period during which the organization was so registered.

This amendment comes into force on Royal Assent.

### Where Information may be Disclosed

ITA
241(4)

Subsection 241(4) of the Act authorizes the communication of information to government officials, outside of the Canada Customs and Revenue Agency, for limited purposes.

One of these purposes is the provision of taxpayer information solely for the purposes of section 24 of the *Statistics Act*. Subsection 241(4) is amended to allow the disclosure of taxpayer information in respect of business activities carried on in a province to provincial statistical agencies. This exception applies only where such information is to be used by the provincial agency solely for research and analysis and that agency is authorized under the law of the province to collect the same or similar information on its own behalf in respect of such business activities.

Subsection 241(4) is also amended to authorize the provision of taxpayer information to a police officer solely for the purpose of investigating whether an offence has been committed, or the laying of an information or the preferring of an indictment, where:

- such information can reasonably be regarded as being relevant for the purpose of ascertaining the circumstances in which an offence under the *Criminal Code* may have been committed, or the identity of the person who may have committed an offence, with respect to an official (or a person related to that official),
- the official was or is engaged in the administration or enforcement of the *Income Tax Act*, and
- the offence can reasonably be considered to be related to that administration or enforcement.

These amendments apply after the enacting legislation receives Royal Assent.

## Clause 187

### Transfer Pricing Capital Adjustment

ITA
247(1)

The "transfer pricing capital adjustment of a taxpayer" as defined in subsection 247(1) of the Act represents the transfer pricing adjustments made under subsection 247(2) that are in respect of capital property and eligible capital property of the taxpayer. The adjustment includes 3/4 of the adjustments with respect to non-depreciable capital property and eligible capital property and 100% of the adjustment with respect to depreciable capital property.

The definition is amended as a consequence of the reduction of the inclusion rate for capital gains from 3/4 to 1/2, with the result that only 1/2, rather than 3/4, of adjustments made under subsection

247(2) with respect to non-depreciable capital property will be included in the taxpayer's transfer pricing capital adjustment for a year.

The amendment applies to taxation years that end after February 27, 2000 except that, for a taxation year of a taxpayer that includes either February 28, 2000 or October 17, 2000 or begins after February 28, 2000 and ends before October 17, 2000, the reference to "1/2" in the definition "transfer pricing capital adjustment" in subsection 247(1) is to be read as reference to the fraction in paragraph 38(*a*) of the Act that applies to the taxpayer for the year. These modifications are required in order to reflect the capital gains/losses rate for the year.

## Transfer Pricing – Contemporaneous Documentation

ITA
247(4)

Section 247 of the Act provides rules relating to transfer pricing for property and services purchased and sold in cross-border transactions and the determination of amounts for income tax purposes.

Subsection 247(4) of the Act requires a taxpayer to document its transactions that are governed by subsection 247(2), failing which the taxpayer may be liable to the penalty provided in subsection 247(3) in respect of a transaction. Liability for the penalty relies in part on the taxpayer not making reasonable efforts to determine arm's length transfer prices or arm's length allocations in respect of the transaction.

The English version of the subsection states that a person is presumed not to have made reasonable efforts unless the person has fulfilled the conditions set out in the subsection, while the French version states that a person may only be deemed to have made reasonable efforts if the person has fulfilled those conditions.

The French version of subsection 247(4) is amended to correspond with the English version of the subsection.

This amendment applies to adjustments made under subsection 247(4) of the Act for taxation years that begin after 1998.

## Clause 188

### Definitions

ITA
248(1)

Section 248 defines a number of terms that apply for the purposes of the Act, and sets out various rules relating to the interpretation and application of various provisions of the Act.

"*alter ego* trust"

The new definition "*alter ego* trust" in subsection 248(1) of the Act refers to a trust to which paragraph 104(4)(*a*) would apply if that paragraph were read without reference to subparagraph 104(4)(*a*)(iii) and clause 104(4)(*a*)(iv)(B). Accordingly, for a trust to be an *alter ego* trust it must satisfy the following conditions:

1. at the time of the trust's creation, the taxpayer creating the trust was alive and had attained 65 years of age;
2. the trust was created after 1999;
3. the taxpayer was entitled to receive all of the income of the trust that arose before the taxpayer's death;
4. no person except the taxpayer could, before the taxpayer's death, receive or otherwise obtain the use of any of the income or capital of the trust; and
5. the trust did not make an election referred in subparagraph 104(4)(*a*)(ii.1).

The definition "alter ego trust" applies to trusts created after 1999. Other amendments related to the introduction of this definition include amendments to section 73, subsections 104(4), (5.8), (6) and (15) and subsection 107(4), and the amended definitions "cost amount" and "trust" in subsection 108(1). For further detail, see the commentary on those provisions.

"authorized foreign bank"

An "authorized foreign bank" means the same thing as that term means under section 2 of the *Bank Act* – that is, a foreign bank in respect of which an order under subsection 524(1) of the *Bank Act* has been made. This new definition relates to Canadian branches of authorized foreign banks and applies after June 27, 1999. In this regard, see the commentary to new section 20.2.

"bank"

A "bank" means a bank within the meaning assigned by section 2 of the *Bank Act* (a "Schedule I" or "Schedule II" bank) or an authorized foreign bank. This new definition relates to Canadian branches of authorized foreign banks and applies after June 27, 1999. In this regard, see the commentary to new section 20.2.

"Canadian banking business"

A "Canadian banking business" is the business carried on by an authorized foreign bank through a permanent establishment in Canada. It excludes, however, business conducted through a representative office registered or required to be registered under section 509 of the *Bank Act*. It is intended that section 8201 of the *Income Tax Regulations* be amended so that its definition "permanent establishment" will apply for the purpose of this definition. This new definition relates to Canadian branches of authorized foreign banks and applies after June 27, 1999. In this regard, see the commentary to new section 20.2 and new paragraph 115(1)(*a*)(ii).

"disposition"

The new definition "disposition" in subsection 248(1) of the Act replaces a definition of the same expression in section 54. The new definition applies for the purposes of the entire Act.

The table below briefly compares the new definition with the former definition, with further detail provided below with regard to the policy changes introduced by the new definition. The first column and second column indicate paragraph references in the new definition and the former definition, respectively. Except as indicated otherwise below, these amendments apply to transactions and events that occur after December 23, 1998.

| New | Old | Description |
|---|---|---|
| (*a*) | (*a*) | Disposition of property by a taxpayer includes transaction or event entitling taxpayer to proceeds. No policy change. |
| (*b*) | (*b*) | Specified redemptions, cancellations, conversions and expirations of debt, equity and options treated as dispositions: no policy change. Bare trusts: see description below |
| (*c*) | (*c*) | Except as otherwise specified, dispositions include transfers to and from trusts. No policy change. |
| (*d*), (*h*) and (*i*) | N/A | Circumstances in which distribution by a trust constitutes disposition of a capital interest in a trust. See description below. |
| (*e*) and (*f*) | (*e*) | Circumstances in which a transfer not a disposition because no change in beneficial ownership. Under the new rules, these circumstances are narrower. See description below and amended subsection 104(1). |
| (*g*) | N/A | Circumstances in which transfers involving RRSPs and RRIFs of the same annuitant not a disposition. See description below. |
| (*j*) | (*d*) | Transfer to secure debt not a disposition. No policy change. |
| (*k*) | N/A | Other transfers to secure obligations not a disposition. See description below. |

| New | Old | Description |
|---|---|---|
| (*l*) | (*f*) | Issue of debt not a disposition. No policy change, but minor technical change. See description below. |
| (*m*) | (*g*) | Issue of share not a disposition. No policy change. |

*Transactions involving capital interests in a trust*

Paragraph (*d*) of the new definition "disposition" applies with respect to capital interests in a trust. Paragraph (*d*) makes it clear that, except as specifically provided in paragraph (*h*) or (*i*), every payment (in kind or otherwise) by a trust to a taxpayer in respect of the taxpayer's capital interest (as defined in subsection 108(1)) in the trust will result in a disposition of all or part of the taxpayer's capital interest in the trust.

The exception under paragraph (*h*) of the new definition "disposition" applies to a payment made by a trust after 1999 where the following conditions are satisfied:

1. the capital interest in the trust is described by reference to units issued by the trust;

2. the payment does not result in a reduction of the number of units in the trust owned by the taxpayer; and

3. the trust is neither a personal trust nor a trust prescribed for the purpose of subsection 107(2).

The exception under paragraph (*i*) of the new definition "disposition" applies to a payment made by a trust after 1999 where the following conditions are satisfied:

1. the payment is made out of the trust's income (determined without reference to subsection 104(6)) or capital gains for a taxation year and the payment was made in the year or the right to the payment was acquired in the year; and

2. the payment is in respect of an amount designated by the trust under subsection 104(20).

Paragraphs (*d*), (*h*) and (*i*) of the new definition "disposition" are part of a set of amendments designed to clarify the tax consequences of distributions from trusts to their beneficiaries after 1999. Generally, results achieved under these rules are intended to accord with existing income tax practice. For further detail, see the notes on amendments to subsections 43(2), 52(6), 107(2) and (2.1) and the definition "capital interest" in subsection 108(1).

*Transactions involving no change in beneficial ownership of property*

Paragraph (*e*) of the new definition "disposition" provides that there is no disposition where a transfer of property does not involve a trust and does not result in a change in the beneficial ownership of the property. Where any of the exceptions in subparagraphs (*e*)(i) to (iii) apply, paragraph (*c*) of the definition will ensure a disposition subject to the exceptions in paragraph (*c*). Paragraph (*e*) takes into account past interpretations of the definition "disposition" in section 54. For example, the Canada Customs and Revenue Agency has taken the position that there is no disposition where an individual's undivided joint ownership interest in real property is converted to a tenancy-in-common interest in the property.

Paragraph (*f*) of the new definition "disposition" provides an exception to the general rule in paragraph (*c*) that a disposition results from any transfer of the property to a trust or, where the property is property of a trust, any transfer of the property to any beneficiary under the trust. Paragraph (*f*) avoids, unless an election is made to the contrary under subparagraph (*f*)(v), a disposition in the case of certain very simple trust-to-trust transfers involving no change in beneficial ownership. For this paragraph to apply, the following additional conditions must be satisfied:

1. the transfer is not from a trust resident in Canada to a non-resident trust;

2. the transferee does not receive the property in satisfaction of the transferee's right as a beneficiary under the transferor trust;

3. the transferee does not hold property immediately before the transfer other than property the cost of which is not included, for the purposes of the Act, in computing a balance of undeducted outlays, expenses or other amounts in respect of the transferee (i.e., subject to subparagraph (*f*)(vii) described in item 6 below, the transferee would be permitted to hold non-depreciable capital property);

4. where the transferor is an amateur athlete trust, a cemetery care trust, an employee trust, an *inter vivos* trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization, a related segregated fund trust (in this paragraph having the meaning assigned by section 138.1), a trust described in paragraph 149(1)(*o*.4) or a trust governed by an eligible funeral arrangement, an employees profit sharing plan, a registered education savings plan or a registered supplementary unemployment benefit plan, the transferee is the same type of trust;

5. the transfer results, or is part of a series of transactions or events that results, in the transferor ceasing to exist; and

6. at all times before the transfer or before the beginning of that series of transactions or events, as the case may be, the transferee held no property or held only property having a nominal value.

Paragraph (*f*) generally will not apply to a transfer of property that occurred before 2000 by an RRSP trust or RRIF trust to a RRIF trust (or by a RRIF trust to an RRSP trust), unless the transferee trust files a written election with the Minister of National Revenue on or before the filing-due date for its taxation year in which the transfer is made (or on such later day as is acceptable to the Minister) that paragraph (*f*) of that definition applies. For transfers of property involving RRSPs and RRIFs and that occur after 1999, where the conditions of paragraph (*f*) are satisfied, that paragraph will apply to avoid a disposition without need for an election. For further detail, see the commentary below on paragraph (*g*) of the new definition "disposition".

Where paragraph (*f*) does apply, new subsection 248(25.1) applies (unless the transfer is to an RRSP trust or RRIF trust) with tax consequences described in the commentary on that subsection.

Where paragraph (*f*) applies to a transfer of property between trusts, the determination of whether there is a disposition of a beneficiary's interest in the transferor trust is a question of fact. However, where the rights of the beneficiary do not change as a result of the transfer, there generally would not be expected to be a disposition of that interest. Where the paragraph does not apply because any of the six additional conditions described above are not satisfied (and paragraph (*g*) also does not apply), the transfer will generally be a qualifying disposition under new subsection 107.4(1).

Where paragraph (*f*) applies and the transfer is to an RRSP trust or RRIF trust, amended subsection 206(4) will not apply. Accordingly, the transfer will generally occur on a rollover basis.

Paragraph (*k*) of the new definition "disposition" also provides an exception to the general rule in paragraph (*c*). Paragraph (*k*) applies to a transfer of property as a consequence of which there is no change in the beneficial ownership of the property. For paragraph (*k*) to apply with no resulting disposition resulting from the transfer of property to a trust, the main purpose of the transfer must be:

- to effect payment under a debt or loan;

- to provide comfort that an absolute or contingent obligation of the transferor will be satisfied; or

- to facilitate either the provision of compensation or the enforcement of a penalty, in the event that an absolute or contingent obligation of the transferor is not satisfied.

Where paragraph (*k*) applies, new subsection 248(25.2) applies with tax consequences described in the commentary on that subsection.

*Transactions involving bare trusts*

Under amended subsection 104(1) of the Act, a trust generally is deemed not to include an arrangement under which the purported trust (in this commentary referred to as a "bare trust") can reasonably be considered to act as agent for all the beneficiaries under the bare trust with respect to all dealings with all of the bare trust's property.

Paragraph (*e*) of the new definition "disposition" generally will apply so that there is no disposition on a transfer of property, involving no change in beneficial ownership, by a settlor to a particular bare trust for the benefit of the settlor. That paragraph also will apply so that there is no disposition because of a transfer of property, involving no change in beneficial ownership, by the particular bare trust back to the settlor. However, where a settlor transfers property to a bare trust for the benefit of another person, the transfer will be considered a disposition of property by the settlor to the other person.

Subparagraph (*b*)(v) of the new definition "disposition" provides that a disposition occurs where a bare trust ceases to act as agent for a beneficiary under the trust with respect to any dealing with any of the trust's property. However, as described above, where a bare trust for the benefit of a settlor ceases to be an agent because of the transfer back to the settlor of the property held under the bare trust, paragraph (*e*) of that definition generally ensures that the transfer back to the settlor of the property will not be considered a disposition (assuming that the transfer does not involve a change in beneficial ownership).

*Transactions involving RRSPs and RRIFs*

Paragraph (*g*) also provides an exception to the general rule in paragraph (*c*) that a disposition results upon the transfer of property to a trust or transfers of property from a trust to a beneficiary of the trust. Paragraph (*g*) of the new definition avoids, unless an election is made to the contrary under subparagraph (*g*)(v), a disposition in the case of certain trust-to-trust transfers involving RRSPs and RRIFs. A transfer under this paragraph is not subject to the restriction in paragraph (*f*) that there be no change in beneficial ownership. For paragraph (*g*) to apply, the following additional conditions must be satisfied:

1. the transferor is an RRSP trust or RRIF trust;

2. the transferee is an RRSP trust or RRIF trust;

3. the transferee does not hold property immediately before the transfer other than property the cost of which is not included, for the purposes of the Act, in computing a balance of undeducted outlays, expenses or other amounts in respect of the transferee (i.e., subject to subparagraph (*g*)(vi) described in

item 5 below, the transferee would be permitted to hold non-depreciable capital property);

4. the transfer results, or is part of a series of transactions or events that results, in the transferor ceasing to exist; and

5. at all times before the transfer or before the beginning of that series of transactions or events, as the case may be, the transferee held no property or held only property having a nominal value.

Paragraph (*g*) generally will not apply to a transfer of property that occurred before 2000 by an RRSP trust or RRIF trust of an annuitant to a RRIF trust of the same annuitant (or by a RRIF trust of an annuitant to an RRSP trust of the same annuitant), unless the transferee trust files a written election with the Minister of National Revenue on or before the filing-due date for its taxation year in which the transfer is made (or on such later day as is acceptable to the Minister) that paragraph (*g*) of that definition applies. For transfers of property involving RRSPs and RRIFs that occur after 1999 and that satisfy the requirements of paragraph (*g*), the paragraph will apply to avoid a disposition without need for an election.

Where paragraph (*g*) applies, amended subsection 206(4) will not apply. Accordingly, the transfer will generally occur on a rollover basis. Where neither paragraph (*f*) nor (*g*) applies, the transfer will generally be a qualifying disposition under new subsection 107.4(1) where the conditions of that provision are met.

***Example 1***

*Imelda arranged the transfer of properties in November 1999 from the RRSP trust under which she was the annuitant to a RRIF trust under which she was the annuitant. Under the RRSP trust the only named beneficiary was Luc. However, under the RRIF trust, Imelda named Gilbert as a beneficiary.*

*Results:*

*1. Because the transfer occurred after December 23, 1998 but before 2000, it will constitute a disposition under paragraph (c) of the definition "disposition", unless the RRIF trust files an election* *that paragraph (g) of that definition applies (paragraph (f) of that definition is intended not to apply where there is a change in beneficial ownership upon the transfer). If the election is filed and the remaining conditions in paragraph (g) are met such that paragraph (g) applies, the transfer would not be a disposition and would generally be expected to occur on a rollover basis because of subsection 206(4).*

*2. If the election referred to in item 1 above is not filed, the transfer would be a disposition that is, if the conditions in subsection 107.4(1) of the Act are met, a "qualifying disposition". For this purpose, paragraph 107.4(2)(b) deems there to be no change in beneficial ownership if the annuitant under the transferor trust is the same individual as the annuitant under the transferee trust. If the transfer is a "qualifying disposition", under subparagraph 107.4(3)(c)(iii) the transfer will occur on a fair market value basis unless subparagraph 107.4(3)(c)(i) applies.*

*3. This result reflects the intent that transfers between RRSPs and RRIFs of the same annuitant that occur before 2000 generally occur on a fair market value basis.*

***Example 2***

*Lucie arranged the transfer of properties in March 2000 from the RRSP trust under which she was the annuitant to a RRIF trust under which she was the annuitant. Under the RRSP trust the only named beneficiary was Paulette. However, under the RRIF trust, Lucie named Jamal as the beneficiary.*

*Results:*

*1. Because the transfer occurred after 1999, if the conditions of paragraph (g) of the definition "disposition" are met, the transfer will not be a disposition unless an election is filed by the transferee under subparagraph (g)(v). (Paragraph (f) of that definition is intended not to apply where there is a change in beneficial ownership upon the transfer). The effect of amended subsection 206(4), which expressly does not apply to a transfer described in paragraph (g) of the definition "disposition" will ensure the intended result that the transfer occur on a rollover basis.*

> *2. If the transferee trust elects out of paragraph (g) of the definition "disposition", the transfer would be a disposition that is, if the conditions in subsection 107.4(1) of the Act are met, a "qualifying disposition". For this purpose, paragraph 107.4(2)(b) deems there to be no change in beneficial ownership if the annuitant under the transferor is the same individual as the annuitant under the transferee. If the transfer is a "qualifying disposition", then under subparagraph 107.4(3)(c)(iv) the transfer will occur on a rollover basis unless subparagraph 107.4(3)(c)(ii) applies.*
>
> *3. This result reflects the intent that transfers between RRSP and RRIF trusts of the same annuitant that occur after 2000 generally occur on a rollover basis.*

Paragraph (*g*) of the definition is part of a set of amendments intended to clarify the tax treatment of transfers of property involving RRSPs and RRIFs. For further detail, see the commentary to paragraphs 107.4(2)(*b*) and (3)(*c*), subsection 206(4) and the new definition "disposition" in subsection 248(1).

*Other transactions*

Paragraph (*l*) of the definition replaces paragraph (*f*) of the definition "disposition" in subsection 54(1), which is repealed. Paragraph (*l*) adds a reference to "hypothecary claim". This amendment is made to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

Except as indicated otherwise above, these amendments apply to transactions and events that occur after December 23, 1998.

"foreign currency"

"Foreign currency" means currency of a country other than Canada. This new definition relates to Canadian branches of authorized foreign banks and applies after June 27, 1999. In this regard, see the commentary to new section 20.2.

"foreign resource expense"

The definition "foreign resource expense" is added to subsection 248(1) of the Act, applicable for the purposes of the Act. The meaning of the expression is as defined in new subsection 66.21(1) of the Act. See the commentary on that subsection for information about this new definition. This amendment applies after 2000.

"foreign resource pool expenses"

The new definition "foreign resource pool expenses" is added to subsection 248(1) of the Act, applicable for the purposes of the Act. Foreign resource pool expenses comprise all foreign resource expenses in respect of all countries (as defined in the definition "foreign resource expense" in new subsection 66.21(1) of the Act) and foreign exploration and development expenses (as defined in subsection 66(15) of the Act). This amendment applies after 2000.

"foreign resource property"

The new definition "foreign resource property" in respect of a country is added, applicable for the purposes of the Act. The definition is structured in the same way as the amended definition "Canadian resource property" in subsection 66(15) of the Act, with necessary modifications to reflect the location of the property in a country outside Canada. This amendment applies after 2000.

"grandfathered share"

The definition "grandfathered share" in subsection 248(1) of the Act is amended to correct a cross-reference as a consequence of the movement of the deeming rule in paragraph 112(2.2)(f) of the Act to new paragraph 112(2.22)(a).

This amendment applies in respect of dividends received after 1998.

"joint spousal or common-law partner trust"

The definition "joint spousal or common-law partner trust" refers to a trust to which paragraph 104(4)(*a*) would apply if that paragraph were read without reference to subparagraph 104(4)(*a*)(iii) and clause 104(4)(*a*)(iv)(A). Accordingly, for a trust to be a joint spousal or common-law partner trust it generally must satisfy the following conditions:

1. at the time of the trust's creation, the taxpayer creating the trust was alive and had attained 65 years of age;

2. the trust was created after 1999;

3. the taxpayer or the taxpayer's spouse or common-law partner was, in combination with the spouse or common-law partner or the taxpayer, as the case may be, entitled to receive all of the income of the trust that arose before the later of the death of the taxpayer and the death of the spouse or common-law partner; and

4. no other person could, before the later of those two deaths, receive or otherwise obtain the use of any of the income or capital of the trust.

The definition "joint spousal or common-law partner trust" applies to trusts created after 1999. Other amendments related to the introduction of this definition include amendments to section 73, subsections 104(4), (5.8), (6) and (15) and subsection 107(4), and the amended definitions "cost amount" and "trust" in subsection 108(1). For further detail, see the commentary on those provisions.

This amendment also reflects changes effected by the Modernization of Benefits and Obligations Act.

"net capital loss"

The definition "net capital loss" in subsection 248(1) of the Act is amended so that it applies except as expressly otherwise provided. This amendment is consequential to the new definition "net capital loss" in subsection 104(21.5) of the Act (which applies for the purposes only of that subsection). For more detail, see the commentary on that subsection.

This amendment applies to taxation years that end after February 27, 2000.

"OSFI risk-weighting guidelines"

The "OSFI risk-weighting guidelines" are those issued by the Superintendent of Financial Institutions under section 600 of the *Bank Act*. These guidelines require an authorized foreign bank periodically to provide to the Superintendent a return listing the bank's risk-weighted on-balance sheet assets and off-balance sheet exposures. It is important to note that, as used here, the guidelines are static: they are the guidelines that apply as of August 8, 2000, and not as they may be modified by the Superintendent from time to time.

This new definition relates to Canadian Branches of authorized foreign banks and applies after June 27, 1999. In this regard, see the commentary to new section 20.2.

"personal trust"

A "personal trust" is defined in subsection 248(1) of the Act as a testamentary trust or an *inter vivos* trust in which no beneficial interest was acquired for consideration payable to the trust or to a contributor to the trust. A special rule within the definition generally ensures that one person (or two or more related persons) can make contributions to a trust and retain an interest under the trust without the prohibition on consideration being considered to apply. This special rule also applies for the purposes of paragraph 53(2)(*h*), which deals with the calculation of the adjusted cost bases of certain trust interests.

The definition is amended so that this special rule is removed from the definition. Instead, the special rule is now provided in new subsection 108(7) (as described in the commentary above).

The definition is also amended to expressly exclude, after 1999, unit trusts (as defined in subsection 108(2) of the Act). The reference to unit trusts is being made in this context because under the old definition "personal trust" it was arguable (but by no means certain) that an unusual type of personal trust might technically satisfy the definition "unit trust" in subsection 108(2).

This amendment applies after December 23, 1998.

"post-1971 spousal or common-law partner trust"

The new definition "post-1971 spousal or common-law partner trust" refers to a trust that would be described in paragraph 104(4)(*a*) if that paragraph were read without reference to subparagraph 104(4)(*a*)(iv). Accordingly, a post-1971 spousal or common-law partner trust must generally satisfy the following conditions:

1. it is a trust under which only the taxpayer's spouse or common-law partner is entitled to receive all of the income of the trust that arose before the death of the spouse or common-law partner; and

2. no person except the spouse or common-law partner could, before the death of the spouse or common-law partner, receive or otherwise obtain the use of any of the income or capital of the trust.

Unlike *alter ego* trusts and joint spousal or common-law partner trusts (referred to in the commentary above), a post-1971 spousal or common-law partner trust may also be created by a taxpayer's will.

The definition "post-1971 spousal or common-law partner trust" applies to trusts created after 1971. Other amendments related to the introduction of this definition includes amendments to section 73, subsections 104(4), (5.8), (6) and (15) and subsection 107(4), and the amended definition of "trust" in subsection 108(1). For further detail, see the commentary on those provisions.

This amendment also reflects changes effected by the *Modernization of Benefits and Obligations Act*.

"qualified donee"

The definition "qualified donee" is being included in subsection 248(1) of the Act so that the existing definition of the expression in subsection 149.1(1) applies for the purposes of the whole Act. This expression is used in new subsections 118.1(5.1), (5.2) and (5.3). The definition "qualified donee" in subsection 149.1(1) refers to specified entities (including registered charities) the gifts to which can give rise to the charitable donations tax credit.

This amendment applies after 1998.

"taxable Canadian property"

One of the key concepts in the Act is the concept of "taxable Canadian property." The term is used for a variety of purposes, mostly but not exclusively to do with the taxation of non-residents and migrants. The scope and functions of the term are, however, less than fully clear, in part because the Act currently includes two definitions. The main definition, in subsection 115(1) of the Act, appears to apply for all purposes of the Act. A second definition, however, is provided in subsection 248(1) of the Act. This second definition both confirms the meaning assigned in subsection 115(1) and provides an extended meaning for certain limited purposes.

To clarify the meaning of "taxable Canadian property" and to simplify the Act, the definition in subsection 248(1) of the Act is made the only one, and the substance of the existing subsection 115(1) definition is incorporated into it. In addition, certain changes are made to the definition to reflect its policy basis and to harmonize its components.

Under this new single definition, taxable Canadian property of a taxpayer at any time in a taxation year includes property of the taxpayer that is:

(a) real property in Canada,

(b) property used or held by the taxpayer in carrying on a business in Canada (including eligible capital property), or inventory of such a business, other than

  (i) property used in carrying on an insurance business, and

  (ii) where the taxpayer is non-resident, ships and aircraft used principally in international traffic and related personal property, if the country in which the taxpayer is resident does not tax the gains of persons resident in Canada from dispositions of such property,

(c) if the taxpayer is an insurer, its designated insurance property for the year,

(d) unlisted shares of Canadian-resident corporations (other than a non-resident-owned investment corporation, unless on the first day of the year the corporation owns taxable Canadian property, and other than a mutual fund corporation),

(e) unlisted shares of non-resident corporations if, at any time during the 60-month (currently 12-month) period that ends at that time, the value of the company's Canadian real and resource properties made up more than half the fair market value of all of its properties, and more than half of the fair market value of the share was derived directly or indirectly from such properties,

(f) listed shares that would be described in paragraph (d) or (e) if those paragraphs included listed shares, or shares of a mutual fund corporation, if at any time during the 60-month period that ends at that time the taxpayer and non-arm's length persons owned 25% or more of the issued shares of any class of the capital stock of the corporation,

(g) certain partnership interests, if at any time in the 60-month (currently 12-month) period that ends at the time, most of the partnership's value is attributable to Canadian property,

(h) capital interests in trusts (other than unit trusts) that are resident in Canada,

(i) units of unit trusts (other than mutual fund trusts) that are resident in Canada,

(j) units of a mutual fund trust if, at any time during the 60-month period that ends at that time, not less than 25% of the units of the trust belonged to the taxpayer and non-arm's length persons,

(k) interests in a non-resident trust if, at any particular time during the 60-month (currently 12-month) period that ends at that time, the trust met a test comparable to the one described in respect of a non-resident corporation in (e) above, and

(l) interests in, and options in respect of, property described in any of paragraphs (a) to (k), whether or not the property exists.

Two additional points should be noted with respect to this new definition. First, in addition to listing the above types of property, the new definition preserves in its paragraphs (*m*) to (*q*) the extended meaning of "taxable Canadian property." That extended meaning now applies for the purposes of section 2, subsection 107(2.001), sections 128.1 and 150 of the Act, and for the purpose of applying paragraphs 85(1)(*i*) and 97(2)(*c*) of the Act to a disposition by a non-resident person. For these purposes, "taxable Canadian property" includes Canadian resource properties, timber resource properties, income interests in trusts resident in Canada, rights to a share of the income or loss under an agreement referred to in paragraph 96(1.1)(*a*) of the Act, and life insurance policies in Canada. Second, the new definition does not include, as the existing one does, property that is not otherwise defined to be taxable Canadian property but that rather is deemed by another provision of the Act to be so. That distinction remains relevant, but the rewording of the definition "excluded property" in subsection 116(6) of the Act makes it unnecessary here.

The amended definition of "taxable Canadian property" generally applies after October 1, 1996. Before December 24, 1998, however, the portion of paragraph (*b*) of the definition before subparagraph (*b*)(i) is to be read as though it were confined to capital property used in carrying on a business in Canada.

ITA
248(25.1)

New subsection 248(25.1) of the Act applies where there is a transfer of a property from a particular trust to another trust (other than a RRSP trust or RRIF trust) in circumstances to which paragraph (*f*) of the definition "disposition" in subsection 248(1) (see the commentary above) applies. The result of the application of paragraph (*f*) is that the transfer does not constitute a disposition. Where this is the case, subsection 248(25.1) deems the other trust after the particular time to be the same trust as, and a continuation of, the particular trust.

The application of subsection 248(25.1) does not affect the personal liabilities under this Act of the trustees of either trust or the application of subsection 104(5.8) or paragraph 122(2)(*f*).

This amendment applies to transfers that occur after December 23, 1998.

ITA
248(25.2)

Subsection 248(25.2) of the Act applies where at any time there is a transfer of property to a trust in circumstances to which paragraph (*k*) of the definition "disposition" in subsection 248(1) applies. Once the property has been transferred, the trust is deemed to deal with the property as agent for the transferor until there is a subsequent change in its beneficial ownership.

This amendment applies to transfers that occur after December 23, 1998.

ITA
248(25.3)

Subsection 248(25.3) of the Act applies where a trust (other than a personal trust or a trust prescribed for the purpose of subsection 107(2)) issues particular units of the trust to a taxpayer directly in satisfaction of a right to a qualifying amount payable from the trust in respect of the taxpayer's capital interest in the trust. Where this is the case, the cost to the taxpayer of the particular units is deemed to equal the amount so payable. In the case of particular units of a trust that are capital property, a qualifying amount payable is one that causes, or but for clauses 53(2)(*h*)(i.1)(A) and (B) of the Act would cause, a reduction under subparagraph 53(2)(*h*)(i.1) to the adjusted cost base of the taxpayer's capital interest. Where the particular units of a trust are not capital property, a qualifying amount payable is one in respect of which subparagraph 53(2)(*h*)(i.1) does not apply but to which that subparagraph would apply if it were read without reference to clauses 53(2)(*h*)(i.1)(A) and (B).

This amendment applies to the 1999 and subsequent taxation years.

ITA
248(25.4)

Subsection 248(25.4) of the Act provides relief from possible double taxation where a taxpayer disposes to another person or a partnership a capital interest in a trust that includes a right to enforce payment of an amount by the trust. If, had the trust satisfied the right, there would have been no disposition of the right because of paragraph (*i*) of the definition "disposition" in subsection 248(1), the amount is added to the cost otherwise determined immediately before the disposition of the taxpayer's capital interest in the trust.

This amendment applies to transfers that occur after December 23, 1998.

***Example***

*Stephanie's capital interest in a unit trust initially consists of 1,000 units that Stephanie purchased on December 23, 2000 for $10,000. The trust has not made an election under subsection 132.11(1) to have a December 15 year end. It makes $400 of its income for its 2000 taxation year payable to Stephanie on December 31, 2000. However, prior to the satisfaction of Stephanie's assignable right to enforce payment of the $400 amount payable, Stephanie sells 1/2 of her capital interest in the trust (i.e., 500 units and 1/2 of the right to enforce payment) to a 3rd party for $5,700.*

*Results:*

*1. Under subsection 104(13), Stephanie is required to include $400 in computing her income for the 2000 taxation year.*

*2. The right to enforce payment of the $400 amount by the trust is treated as part of Stephanie's capital interest in the trust under subsection 108(1). Under paragraph (i) of the definition "disposition" in subsection 248(1), a payment by the trust in satisfaction of the right would not be a disposition. However, the sale of the 500 units in the trust is a disposition of part of Stephanie's capital interest that includes a part of her right to enforce payment from the trust.*

*3. As the ACB of the right disposed of is nil, Stephanie realizes a capital gain of $200 (i.e., 1/2 of the total amount to which the right to enforce relates) upon its sale to the 3^rd^ party. Subsection 248(25.4) is intended to apply in these circumstances to provide a $200 "bump" in the ACB of her capital interest in the trust otherwise determined immediately before the disposition. Consequently, the total ACB of the 500 units sold is $5,200 (i.e., $5,000 + $200).*

*4. Consequently, the capital gain realized on the disposition of the 500 units is $500 ($5,700 - $5,200).*

## Prescribed Stock Exchange Rule

ITA
248(29)

New subsection 248(29) of the Act relates to prescribed stock exchanges.

This new subsection allows for the addition of a part, division or subdivision of a stock exchange to the list of either prescribed stock exchanges in Canada (*Income Tax Regulation* 3200) or prescribed foreign stock exchanges (*Income Tax Regulation* 3201). If a part, division or subdivision of a stock exchange is prescribed then that part, division or subdivision is deemed to be a prescribed stock exchange for the purposes of the Act.

This provision applies after October 1999.

## Clause 189

## Definition of "Fiscal Period"

ITA
249.1(1)

Subsection 249.1(1) of the Act provides the definition "fiscal period" for the purposes of the Act. Paragraph 249.1(1)(*b*) provides restrictions on the timing of fiscal periods of certain individuals, trusts, partnerships and professional corporations (other than the fiscal period of a business not carried on in Canada or of a prescribed business). For technical reasons related to the promulgation of *Income Tax Regulations*, paragraph 249.1(1)(*b*) is amended so that the exception refers to a business that is "carried on by a prescribed person or partnership" as well as to a "prescribed business".

This amendment applies to fiscal periods that begin after 1994.

## Clause 190

### Deemed Non-Resident

ITA
250(5)

Subsection 250(5) of the Act deems a person not to be resident in Canada at a time if, at that time, the person, who would otherwise be resident in Canada under the Act, "tie-breaks" under a tax treaty as a resident of a treaty country.

Although non-resident, an authorized foreign bank may in certain cases claim foreign tax credits under section 126 of the Act. This is accomplished by an amendment to that section (new paragraph 126(1.1)(*a*)) that treats the bank as resident in Canada for foreign tax credit purposes.

This amendment to subsection 250(5) ensures that the residence deeming rule in new paragraph 126(1.1)(*a*) is not overridden by subsection 250(5). That is, an authorized foreign bank may still be deemed to be resident in Canada for foreign tax credit purposes, even if subsection 250(5) confirms that it is resident in another country for other purposes.

This amendment applies after June 27, 1999, subject to an existing transitional rule applicable to persons resident on February 24, 1998 under a tax treat in a country other than Canada.

ITA
250(6.1)

New subsection 250(6.1) of the Act applies where a trust ceases to exist. The subsection provides that a trust that ceases to exist at any time in a calendar year, and that was resident in Canada immediately before it ceased to exist, is deemed to be resident in Canada during the remaining period in the year. The Canada Customs and Revenue Agency (CCRA) takes the position that a trust's taxation year is generally not affected by the termination of the trust. Subsection 250(6.1) is meant to avoid unintended consequences of the CCRA's position that arise under a number of provisions of the Act that require a trust to be resident in Canada throughout a taxation year (e.g. flow-through rules under section 104). Subsection 250(6.1) is similar to new subsection 132(6.2), described in the commentary above.

This amendment applies to the 1990 and subsequent taxation years.

## Clause 191

### Non-Resident Person's Taxation Year and Income

ITA
250.1

New section 250.1 of the Act contains clarifying rules that apply for greater certainty, unless the context requires otherwise.

New paragraph 250.1(*a*) provides that, unless the Minister of National Revenue provides otherwise, the taxation year of a non-resident person is determined in the same manner as that of a person resident in Canada.

New paragraph 250.1(*b*) clarifies that a person for whom "income" for the year is determined in accordance with the Act includes a non-resident person. It is a non-resident person's "taxable income earned in Canada" that is relevant for the purposes of computing the person's tax liability under Part I. However, a non-resident person does, in some narrow cases, have "income" for purposes of the Act. For example, there are references to a non-resident's "income" (rather than "taxable income earned in Canada") in paragraphs 212(1)(*c*) and 216(1)(*b*) and subparagraph 217(3)(*b*)(ii). In addition, the "income" of a non-resident person may affect the tax liability of a person resident in Canada (e.g., subsection 104(13)).

New section 250.1 applies after December 17, 1999.

## Clause 192

## Arm's Length

ITA
251(1)

Section 251 of the Act defines the circumstances in which persons are considered not to deal with each other at arm's length for the purposes of the Act.

Subsection 251(1) is amended to ensure that a taxpayer and a specified personal trust (i.e., a personal trust other than one described in any of paragraphs (*a*) to (*e*.1) of the definition "trust" in subsection 108(1)) are deemed not to deal with each other at arm's length if the taxpayer, or any person not dealing at arm's length with the taxpayer, is beneficially interested in the trust. (In determining whether a person is "beneficially interested" in a trust for this purpose, subsection 248(25) is read without reference to subclauses 248(25)(*b*)(iii)(A)(II) to (IV), which provide an extended meaning of this expression.) The non-arm's length relationship is relevant, for example, in applying amended subsection 69(1).

This amendment applies after December 23, 1998, but for the purpose of applying the definition "taxable Canadian property" in subsection 248(1) of the Act it applies only in respect of property acquired after December 23, 1998.

## Clause 193

### Investments in Limited Partnerships

ITA
253.1

New section 253.1 of the Act applies for the purposes of subparagraph 108(2)(*b*)(ii) (definition of "unit trust"), paragraphs 130.1(6)(*b*) (definition of "mortgage investment corporation"), 131(8)(*b*) (definition of "mutual fund corporation"), 132(6)(*b*) (definition of "mutual fund trust"), 149(1)(*o*.2) and the definition "private holding corporation" in subsection 191(1) of the Act, where a trust or corporation holds an interest as a limited partner in a limited partnership. Section 253.1 also applies for the purposes of *Income Tax Regulations* made for the purpose of paragraph 149(1)(*o*.3) (i.e., section 5101 of the Regulations) and paragraph 149(*o*.4) (i.e., section 5001 of the Regulations). These regulations define the expressions "small business investment corporation "and "master trust".

For the purposes of applying the above-noted provisions and definitions where a trust or corporation is a member of a limited partnership, the member will not, solely because of its acquisition and holding of that interest, be considered to carry on any business or other activity of the partnership.

This amendment is limited in its application to ensuring that the mere acquiring and holding of a limited partnership interest by a trust or corporation will not jeopardize the classification of the trust or corporation under those income tax provisions that require the trust or corporation to limit its undertakings to investing. It responds, in part, to the reasoning of the Federal Court of Appeal in *Robinson (Trustee of) v. R.*, [1998] 1 CTC 272, 98 DTC 6065, which, in another context, clarified that limited partners carry on the business of a partnership. As a consequence of this amendment, the meanings of the specified definitions will be determined with reference to new section 253.1 wherever the definitions are used in the Act or Regulations.

This amendment generally applies after 1992.

## Clause 194

### Associated Corporations – Simultaneous Control

ITA
256(6.1)

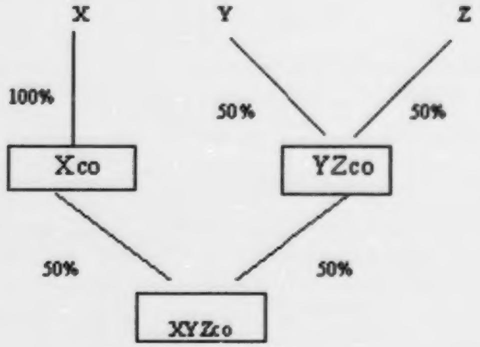
Section 256 of the Act provides rules relevant to the determination, for the purposes of the Act, of whether corporations are associated, whether a corporation is controlled by a person or group of persons, and whether control of a corporation has been acquired.

New subsection 256(6.1) of the Act specifies, for greater certainty, that a corporation may be controlled simultaneously by persons or groups at more than one level above it in a corporate chain.

Paragraph 256(6.1)(*a*) specifies that, where a subsidiary would be controlled by its parent if the parent were not itself controlled by any other person or group, the subsidiary is considered to be controlled both by the parent and by the person or group that controls the parent.

Paragraph 256(6.1)(*b*) is a rule of similar effect that applies where the subject corporation would be controlled by a group (the "first-tier group") if no member of the first-tier group were itself controlled by a third party. In that case, the subject corporation is considered to be controlled both by the first-tier group, and by any higher-tier group which includes, in respect of each member of the first-tier group, either the member or a person or group by whom the member is controlled. If one person controls all members of the first-tier group, that person would constitute a higher-tier group.

The operation of paragraph (*b*) is illustrated by the following example, in which the percentages represent ownership of voting shares, and the various groups identified are assumed to act in concert in voting their shares.



In this example, XYZco is considered to be simultaneously controlled by:

(i) the first-tier group comprised of Xco and YZco,
(ii) the higher-tier group comprised of X, Y and Z,
(iii) the higher-tier comprised of Xco, Y and Z, and
(iv) the higher-tier group comprised of X and YZco.

While the concepts set out in subsection 256(6.1) deal directly only with a corporation and persons in the two levels of ownership immediately above it, application of the provision sequentially from the top of a chain makes it applicable to corporate chains with three or more levels.

New subsection 256(6.1) applies after November 1999.

**Application to Control in Fact**

ITA
256(6.2)

New subsection 256(6.2) of the Act specifies that the rule regarding simultaneous control in new subsection 256(6.1) also applies to the concept of *de facto* control, which is set out in subsection 256(5.1) of the Act.

New subsection 256(6.2) applies after November 1999.

### Clause 195

### Deemed Interest on Preferred Shares

ITA
258(3)

Section 258 of the Act contains deeming provisions that complement the rules set out in section 112 of the Act, which disallow the intercorporate dividend deduction in respect of dividends paid on certain preferred shares and so-called guaranteed shares.

Subsection 258(3) of the Act provides that certain dividends received by a corporation from a corporation not resident in Canada are to be treated for certain purposes as having been received in the form of interest. This subsection is amended to correct a cross-reference as a consequence of the movement of the deeming rule in paragraph 112(2.2)(f) of the Act to new paragraph 112(2.22)(a).

This amendment applies in respect of dividends received after 1998.

## Part 2 – Harmonization with the Civil Code of Quebec

### Clauses 196 to 237

As a consequence of the coming into force of a new Civil Code in Quebec on January 1, 1994, the federal government has begun the Program to Harmonize Federal Legislation with the Civil Law to recognize changes in terminology and new substantive rules made by the new Code, which impact on federal legislation dealing with concepts of provincial private law.

As part of this harmonization effort, federal tax legislation is being reviewed. Modifications to the legislation will be implemented over a period of time to reflect the proper terminology and rules of the new Code.

This Part proposes amendments to the Income Tax Act, the Income Tax Application Rules and the Excise Tax Act incorporating, where necessary, the concepts of "hypothec", "liquidator of a succession" and "co-ownership" which are further described below. The proposed amendments are not intended to change the current application of the amended provisions. They will come into force on Announcement Date.

## Hypothec

In the current tax legislation, the concept of "mortgage" is used in the English version to reflect both the common law concept of "mortgage" and the civil law concept of "hypothec". However close, these concepts are fundamentally different. It is therefor appropriate to add a reference to "hypothec" and related expressions like "hypothecary debtor", "hypothecary creditor" and "hypothecary claim" to properly reflect the civil law.

The French version of the legislation does not need parallel amendments because the current term "hypothèque" designates the civil law concept as well as the correct French terminology of the common law concept of "mortgage".

## Liquidator of a succession

The former institution of "executor" of a succession has been replaced, in the new Code, by a "liquidator of  succession" who exercises slightly different functions. In the English version, the reference to "executor" is still appropriate to reflect the common law, but a reference to "liquidator of succession" needs to be added to reflect the civil law. In the French version, "exécuteur testamentaire" is still the correct reference for the common law, but "liquidateur de succession" is added to reflect the new concept under the civil law.

## Co-Ownership

The concept of "joint ownership" (propriété conjointe) is unique to the common law as it usually refers to the concept of "joint tenancy" and does not exist is Quebec civil law. The term "co-ownership" is neutral and known to both legal systems. It is appropriate in civil law and is broad enough to include the common law concepts of "joint tenancy" and "tenancy in common".

To avoid any possible reference to the concept of "joint tenancy", either the words "joint" and "jointly" have been removed or the expression "jointly owned" has been replaced by "co-owned". Similarly, in the French version, "propriété conjointe" is replaced by "copropriété" or the word "conjointe" is deleted where unnecessary.

In addition, further changes not relating to the harmonization have been made to clause 224.

### Registered Investments

ITA
Part X.2

Part X.2 of the Act provides that a trust or corporation may apply to become a registered investment for a registered retirement savings plan, a registered retirement income fund or a deferred profit sharing plan. Subsection 204.4(2) sets out the requirements that must be met by a trust or corporation in order to become a registered investment.

Clause 204.4(2)(*a*)(ii)(A) of the Act is amended to add debentures, hypothecary claims, notes and other similar obligations to the list of properties the combination of which must account for at least 80 per cent of a trust's or corporation's total properties where the trust or corporation seeks to qualify under paragraph 204.4(2)(*a*) to be registered investment.

Subparagraph 204.4(2)(*a*)(viii) of the Act is amended so that a trust or corporation that seeks to qualify under paragraph 204.4(2)(*a*) to be a registered investment may hold property that is a mortgage or hypothecary claim insured by a corporation that offers its services to the public in Canada as an insurer of mortgages and that is approved as a private insurer of mortgages by the Superintendent of Financial Institutions pursuant to the powers assigned to the Superintendent under subsection 6(1) of the Office of the Superintendent of Financial Institutions Act.

These amendments to Part X.2 apply to property acquired after Announcement Date.

## Part 3 – Technical Amendments to the Income Tax Act

### Clauses 238 to 248

This Part amends various provisions of the *Income Tax Act* to reflect additional changes to it necessitated by the *Modernization of Benefits and Obligations Act.*

## Amendment to the Income Tax Application Rules

### Clause 249

### Additions to Taxable Canadian Property

Income Tax Application Rules
26(30)

Section 26 of the *Income Tax Application Rules* sets out the method for computing the adjusted cost base to a taxpayer of certain capital property owned by the taxpayer at the end of 1971. The general purpose of section 26 is to prevent gains that accrued before 1972 from being subject to tax.

Subsection 26(30) of the Rules provides that dispositions by non-residents persons of certain types of property are not within the application of subsections 26(1.1) to (29) of the rules. Essentially, these are properties that became taxable Canadian properties because of changes to the definition "taxable Canadian property" that took effect in April, 1995. The relief provided by section 26 is not needed for such properties, as subsection 40(9) of the *Income Tax Act* ensures that a non-resident person's gains or losses on the disposition of such properties are limited to those that accrued after April 1995.

This amendment to subsection 26(30) of the rules ensures that the provision does not apply to property that becomes taxable Canadian property as a result of these proposals. The amendment applies to dispositions that occur after October 1, 1996.

## Clause 250

### Disposition of Partnership Property

*S.C. 1991, C.49*
236(1)

*Income Tax Act*
98(3) and (5)

Subsection 98(3) of the *Income Tax Act* is an elective provision permitting property of a Canadian partnership which has ceased to exist to be distributed to its members, for proceeds to the partnership and at a cost to the members, equal to the cost amount of the property to the partnership, provided certain conditions are met. Where those conditions are met, this provision allows a special increase or "bump-up" in the tax value of the distributed partnership property where the adjusted cost base of a member's partnership interest exceeds the amount of any money and the cost amount to the partnership of the property which the member has received upon the dissolution.

Paragraph 98(3)(*d*), which allowed one-half of this excess to be allocated to property other than non-depreciable capital property up to the fair market value of the property, was repealed, applicable in respect of certain events that occur after December 4, 1985. That paragraph, which continues to apply in respect of certain "grandfathered" partnership property, was amended in the past as the result of changes to the inclusion rate for capital gains.

Subsection 98(5) of the Act contains rules which provide a tax-deferred transfer or "rollover" of a Canadian partnership's property where the partnership has ceased to exist and the transfer is to one member of the partnership who continues to carry on the business of the partnership as a sole proprietor.

Where the adjusted cost base of the member's partnership interest, including the interests acquired from other members, exceeds the amount of any money and the cost amount to the partnership of the property received by the proprietor upon the dissolution, the member may designate this excess to be added to the cost base of one of more particular properties.

Paragraph 98(5)(*d*), which allowed one-half of this excess to be allocated to property other than non-depreciable capital property, was repealed, applicable in respect of certain events that occurred after December 4, 1985. That paragraph, which continues to apply to certain "grandfathered" partnership property, was amended in the past as results of the changes to the inclusion rate for capital gains.

The grandfathering provisions in paragraphs 98(3)(*d*) and (5)(*d*) are amended to replace a taxpayer's 3/4 capital gains inclusion rate used in the paragraph in a taxation year or fiscal period to the fraction required to be used by the taxpayer in the year or fiscal period under paragraph 38(*a*) or (*b*) of the Act.

These amendments are deemed to have come into force on December 19, 1986.

## Clause 251

### Loss on Share that is Capital Property – Transitional Rules

S.C. 1998, c. 19, s. 131(11)(*b*)(iv)

Subsection 112(3) of the *Income Tax Act* contains a "stop-loss" rule that reduces a taxpayer's loss arising on the disposition of a share of the capital stock of a corporation by the amount of certain dividends received by the taxpayer on the share. This rule, as amended by the *Income Tax Amendments Act*, 1997, generally applies to share dispositions that occur after April 26, 1995. However, the rule does not apply to share dispositions that occur in the situations described in paragraph 131(11)(*b*) of that Act. Consequential to the extension of the rollover rules in section 73 of the *Income Tax Act* to certain trusts created after 1999, this amendment generally extends the transitional relief provided by paragraph 131(11)(*b*) of the *Income Tax Amendments Act*, 1997, to a disposition of a share by such a trust. This amendment also reflects changes effected by the *Modernization of Benefits and Obligations Act*.

This amendment generally applies to the 2000 and subsequent taxation years.

## Clause 252

### Taxable Capital Employed in Canada – Life Insurance Corporations

S.C. 1998, c. 19, s. 206

Subsection 190.1(1.1) of the *Income Tax Act* imposes an additional temporary Part VI tax on the taxable capital employed in Canada of life insurance corporations. Section 206 of the *Income Tax Amendments Act, 1997* provided that deferred realized gains and losses of life insurance corporations on investment properties would not be added or deducted in computing the Part VI tax base. Consequential to the extension of the additional tax to December 31, 2000, this amendment extends the exclusion of deferred realized gains and losses in calculating the Part VI tax base to the same date.

This amendment applies to taxation years that end after 1998.

## Clause 253

### Deemed Non-Resident

S.C. 1999, c. 22, ss. 82(8)

Prior to 1998, subsection 250(5) of the *Income Tax Act* contained a deeming rule applicable to corporations – where a corporation that would otherwise be resident in Canada was, under a tax treaty between Canada and another country, resident in the other country, the rule deemed the corporation not to be resident in Canada for the purposes of the *Income Tax Act*.

Subsections 82(4) and 82(8) of the *Income Tax Amendments Act, 1998* extended this rule to both corporations and other persons – new subsection 250(5) deems a person not to be resident in Canada at a time if, at that time, the person, who would otherwise be resident in Canada under the *Income Tax Act*, "tie-breaks" under a tax treaty as a resident of a treaty country. This new rule was intended to be effective after February 24, 1998, except that an individual who was resident both in Canada and in a treaty country on that day was not to be subject to the new rule until the first time after February 24, 1998 at which that individual "tie-breaks" as a resident of a treaty country other than Canada.

Due to a possible ambiguity in the wording of the coming-into-force provision, subsection 82(8) of the *Income Tax Amendments Act, 1998* is now being clarified to ensure that amended subsection 250(5) applies as described above.

The new coming-into-force provision is deemed to have come into force on June 17, 1999, the day on which the *Income Tax Amendments Act, 1998* received Royal Assent.

## Amendments to the Canada Pension Plan

### Clause 254

### Amount of Contributory Salary and Wages

CPP
12(1)

Subsection 12(1) of the *Canada Pension Plan* (CPP) defines a person's "contributory salary and wages" for a year, which is the basis on which contributions are to be made under the plan. The amount of a person's contributory salary and wages for a year is the person's income for the year from employment, computed in accordance with the *Income Tax Act* (ITA), plus any deductions for the year made in computing that income (otherwise than under paragraph 8(1)(*c*) of the ITA).

Subsection 12(1) of the CPP is amended to provide that, in computing a person's income from employment under the ITA, subsection 7(8) of the ITA is to be disregarded. Under that subsection 7(8), the benefit realized when a person acquires a qualifying security under an employee option agreement is not included in computing the person's employment income until the year in which the person disposes of the security. However, if subsection 7(8) of the ITA were disregarded, the benefit would be included in computing the person's employment income for the year in which the security is acquired.

The effect of the amendment to subsection 12(1) of the CPP is to provide that, even though an employment benefit to which subsection 7(8) of the ITA applies is not taxed until the person disposes of the related security, the benefit is treated for CPP purposes as though it were included in the person's employment income in the year in which the security is acquired. Accordingly, the benefit is relevant for determining CPP contributions in the year of acquisition, rather than in the year of disposition. This ensures that employers – who have no reporting obligations under the ITA in respect of such amounts beyond the year in which the security is acquired – are able to comply with their remittance obligations under the CPP. (For further details, see the commentary on new subsections 7(8) to (16) of the ITA, and the commentary in Appendix A on proposed subsection 200(5) of the *Income Tax Regulations*.)

This amendment applies to the 2000 and subsequent taxation years. New subsection 7(8) of the ITA applies to qualifying securities acquired after February 27, 2000.

## Amendments to the Customs Act

### Clauses 255 and 256

### Hindering an Officer

*Customs Act*
153.1 and 160.1

New section 153.1 of the *Customs Act* prohibits anyone from hindering, molesting or interfering with, or attempting to hinder, molest or interfere with, an official who is performing any act that the official is authorized to perform under the Act.

New section 160.1 makes it an offence for anyone to contravene section 153.1. Every person who is guilty of an offence under section 160.1 is liable, on summary conviction, to a fine of between $1,000 and $25,000 or to such a fine and a term of imprisonment of up to one year. These amendments are consistent with the offence provisions under section 238 of the *Income Tax Act* for failure to comply with subsection 231.5(2) of that Act, and under section 326 of Part IX of the *Excise Tax Act* for failure to comply with subsection 291(2) of that Act, as amended.

New sections 153.1 and 160.1 come into force on Royal Assent.

## Amendments to the Excise Tax Act

### Clause 257

### Compliance

*Excise Tax Act*
101

New section 101 of the *Excise Tax Act* makes it an offence to hinder, molest or interfere with, or attempt to hinder, molest or interfere with, an official who is performing any act that the official is authorized to perform under Parts I to VII of the Act. This section also makes it an offence to prevent or attempt to prevent an official from performing such an act. Every person who is guilty of an offence under this provision is liable, on summary conviction, to a fine of between $1,000 and $25,000 or to such a fine and a term of imprisonment of up to one year. This section is consistent with the offence provisions under section 238 of the *Income Tax Act* for failure to comply with subsection 231.5(2) of that Act, and under section 326 of Part IX of the *Excise Tax Act* for failure to comply with subsection 291(2) of that Act, as amended.

New section 101 comes into force on Royal Assent.

## Clause 258

### Compliance Order

ETA
289.1

Sections 288 to 292 of the *Excise Tax Act* set out the rules relating to the powers of tax administrators to audit and examine books and records for the purposes of the Goods and Services Tax and Harmonized Sales Tax under Part IX of the Act. In particular, section 288 authorizes the inspection, audit and examination of books, records and property, and section 289 provides that a person may be required, by notice, to provide information or documents relating to the administration or enforcement of Part IX of the Act. If a person refuses to comply with section 288 or 289, the person is subject to criminal prosecution under section 326 of the Act.

New section 289.1 provides an alternative means of enforcing compliance with sections 288 and 289. Where a person has failed to comply, subsection 289.1(1) allows the Minister of National Revenue to seek, by way of summary application, a court order requiring the person to provide the access, assistance, information or document sought under section 288 or 289. Under subsection 289.1(2), the person must be given notice of the application at least five clear days before it is heard. Subsection 289.1(3) gives the judge hearing the application the discretion to impose such conditions on the order as the judge considers appropriate.

Subsection 289.1(4) provides that a person who refuses to comply with the judge's order may be found in contempt of court and will be subject to the processes and punishments of the court to which the judge is appointed.

Subsection 289.1(5) provides that an order made under this new provision may be appealed to the court that has appellate jurisdiction over the court to which the judge that made the order is appointed, but that the execution of the order is not suspended unless it is so ordered by the court to which the appeal is made.

New section 289.1 comes into force on Royal Assent.

## Clause 259

### Compliance

*Excise Tax Act*
291(2)

Subsection 291(2) of the *Excise Tax Act* prohibits a person from hindering, molesting or interfering with an official performing certain administrative and enforcement functions under Part IX of the Act. The subsection also prohibits a person from preventing or attempting to prevent an official from performing those functions. The existing provision does not apply in the context of an official who is performing a collection duty, or to attempts to hinder, molest or interfere with an official.

Subsection 291(2) is amended to apply in respect of any act that the official is authorized under Part IX of the Act to perform. The provision is also amended to prohibit a person from attempting to hinder, molest or interfere with an official who is performing any such act.

Subsection 291(2) is further amended to place a positive obligation on a person to do everything the person is required to do by or pursuant to the audit and examination provisions of Part IX of the Act (i.e., sections 288 to 292). This amendment is made as a consequence of certain wording changes to subsection 326(1) of the *Excise Tax Act*, which makes it an offence to, among other things, not comply with these audit and examination provisions (see the commentary on subsection 326(1) of the *Excise Tax Act*). Amended subsection 291(2) parallels the wording of the corresponding provision of the *Income Tax Act*, subsection 231.5(2), as amended.

This amendment comes into force on Royal Assent.

## Clause 260

### Provision of Information

*Excise Tax Act*
295(5)(*l*)

Section 295 of the *Excise Tax Act* prohibits the use or communication of information obtained under Part IX of the Act by an official unless specifically authorized by one of the exceptions found in that section. Subsection 295(5) of the Act specifies certain situations where such information may be communicated by an official.

Subsection 295(5) is amended to add new paragraph (*l*) which authorizes the provision of confidential information by an official to a police officer solely for the purpose of investigating whether an offence under the *Criminal Code* has been committed against an official, or a person related to the official, who was or is engaged in the administration or enforcement of the Goods and Services Tax or the Harmonized Sales Tax. This provision would apply only if the alleged offence can reasonably be considered to be related to that administration or enforcement.

This amendment comes into force on Royal Assent.

## Clause 261

### Offences

*Excise Tax Act*
326(1)

Existing subsection 326(1) of the *Excise Tax Act* makes it an offence to fail to file or make a return as and when required by or under Part IX of the *Excise Tax Act*, or to fail to comply with an obligation under certain provisions relating to keeping books and records and to inspections and requests for information by the Minister of National Revenue or an official. A person who is found guilty of an offence under this provision is liable on summary conviction to a fine of between $1,000 and $25,000 or to such a fine and a term of imprisonment of up to one year.

This subsection is amended so that it is also an offence under this provision to fail to comply with the prohibition under subsection 291(2) of the Act dealing with hindering or interfering with an official. Specifically, amended subsection 291(2) prohibits a person from hindering, molesting or interfering with an official performing, or preventing an official from performing, any function that the official is authorized to perform under Part IX of the *Excise Tax Act*. Subsection 291(2) also prohibits a person from attempting to hinder, molest or interfere with an official. The extension of the penalty under subsection 326(1) to this particular offence parallels the corresponding penalty under the *Income Tax Act*, subsection 238(1).

In addition, subsection 326(1) is amended to coincide with amended subsection 291(2) which imposes the positive obligation on a person to do everything that the person is required to do under the audit and examination provisions of Part IX of the Act (i.e., sections 288 to 292). As a consequence, it is no longer necessary for subsection 326(1) to refer directly to a failure to comply with the obligations under sections 288, 289 and 292. It is sufficient to refer to a failure to comply with subsection 291(2).

These amendments come into force on Royal Assent.

## Clause 262

## Offence re Confidential Information

Excise Tax Act
328(2)(*a*)

Section 328 of the *Excise Tax Act* makes it an offence to contravene the confidentiality provisions in section 295 of the Act regarding information gathered by the Canada Customs and Revenue Agency in the administration or enforcement of the Goods and Services Tax and the Harmonized Sales Tax (GST/HST). A person who is found guilty of an offence under this provision is liable on summary conviction to a fine of up to $5,000, to a term of imprisonment of up to one year, or to both.

In particular, paragraph 328(2)(*a*) of the Act makes it an offence for a person who received such confidential information for a particular purpose specified in certain paragraphs of subsection 295(5) of the Act to use the information or provide the information to another person for any other purpose. This paragraph is amended to refer to information provided to a person under new paragraph 295(5)(*l*) of the Act, which allows the disclosure of confidential information to a police officer solely for the purpose of investigating whether an offence under the *Criminal Code* has been committed against an official, or a person related to the official, who was or is engaged in the administration or enforcement of the GST/HST.

This amendment comes into force on Royal Assent.

## Part 11 – Modernization of Benefits and Obligations Act

### Clause 263

This Part corrects a reference, in the amending clause found in subsection 134(2) of the *Modernization of Benefits and Obligations Act*, to the definition "member of a congregation" in subsection 143(4) of the *Income Tax Act*.

### Clause 264

*Sales Tax And Excise Tax Amendments Act, 1999*
171

The French version of section 171 of the *Sales Tax And Excise Tax Amendments Act, 1999* incorrectly refers to "paragraphe 166.67.2(2)" of the *Income Tax Act*. That reference is corrected to "paragraphe 166.2(2)" effective October 20, 2000, the date of Royal Assent to the *Sales Tax And Excise Tax Amendments Act, 1999*.

# APPENDIX A

## DRAFT *INCOME TAX REGULATION* AND EXPLANATORY NOTES

### Information Returns

**1. Section 200 of the *Income Tax Regulations* is amended by adding the following after subsection (4):**

(5) Where a particular qualifying person (within the meaning assigned by subsection 7(7) of the Act) has agreed to sell or issue a security (within the meaning assigned by subsection 7(7) of the Act) of the particular qualifying person (or of a qualifying person with which it does not deal at arm's length) to a taxpayer who is an employee of the particular qualifying person (or of a qualifying person with which the particular qualifying person does not deal at arm's length) and the taxpayer has acquired the security under the agreement in circumstances to which subsection 7(8) of the Act applied, each of the particular qualifying person, the qualifying person of which the security is acquired and the qualifying person which is the taxpayer's employer shall, for the particular taxation year in which the security is acquired, make an information return in prescribed form in respect of the benefit from employment that the taxpayer would be deemed to have received in the particular taxation year in respect of the acquisition of the security if the Act were read without reference to subsection 7(8) and, for this purpose, an information return made by one of the qualifying persons in respect of the taxpayer's acquisition of the security is deemed to have been made by each of the qualifying persons.

**2. Section 1 applies to the 2000 and subsequent taxation years.**

## INFORMATION RETURNS

### EXPLANATORY NOTES

ITR
200(5)

New subsection 200(5) of the *Income Tax Regulations* contains special reporting requirements relating to securities acquired under employee option agreements in circumstances to which new subsection 7(8) of the *Income Tax Act* applies. Under that subsection 7(8), taxation of the employment benefit arising from the acquisition of an employee option security after February 27, 2000 is deferred until the employee disposes of the security, provided certain conditions are met. Although taxation is deferred, new subsection 200(5) of the Regulations requires that an information return reporting the deferred amount be filed with the Minister of National Revenue in the year in which the employee acquires the security.

Under subsection 200(5), each of the following parties is jointly liable for filing the information return: the employer, the entity that granted the option under which the security is acquired and the entity whose security is acquired under the option. However, each of the parties is considered to have satisfied the filing requirement if one of the parties satisfies the requirement. This allows the parties involved in the agreement to determine who should be responsible for reporting the deferred employment benefit.

Subsection 200(5) requires that the information return be made in prescribed form as determined by the Minister of National Revenue. The prescribed form will be the employee's T4 slip for the year in which the security is acquired, and the deferred amount will be reported as a separate item on that slip.

It should be noted that this requirement is the only reporting requirement relating to the deferred employment benefit that is imposed on the parties involved in the option agreement. The onus is on the employee to include the deferred amount in computing employment income when filing the tax return for the year in which the security is disposed of.

New subsection 200(5) of the Regulations applies to the 2000 and subsequent taxation years.

# APPENDIX B

## DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

### Taxpayer Migration

**1. (1) Subsections 600(*c*) of the *Income Tax Regulations* is replaced by the following:**

(*c*) paragraphs 48(1)(*a*) and (*c*), 66.7(7)(*c*), (*d*) and (*e*) and (8)(*c*), (*d*) and (*e*), 80.01(4)(*c*) and 128.1(4)(*d*), (6)(*a*) and (*c*) and (7)(*c*) of the Act;

**(2) Subsection (1) applies after October 1, 1996.**

**2. (1) The portion of section 2606 of the Regulations before subsection (3) is replaced by the following:**

Limitations of business income

(1) If, in the case of an individual to whom section 2601, applies, the total of the amounts otherwise determined as the individual's income for a taxation year from carrying on business earned in all provinces and countries other than Canada is greater that the individual's income for the year, the individual's income for the year from carrying on business earned in a particular province or country is deemed to be that proportion of the individual's income for the year that

(a) the individual's income for the year from carrying on business in the province or country as otherwise determined,

is of

(*b*) that total.

(2) If section 114 of the Act applies in respect of an individual for a taxation year, the reference in subsection (1) to "the individual's income for a taxation year" shall be read as a reference to the amount of the individual's taxable income for the year and, for the purpose of

this Part, the individual's income for the year from carrying on a business in any place shall be computed by reference only to a business the income from which is included in computing the individual's taxable income for the year.

**(2) Subsection (1) applies to the 1998 and subsequent taxation years.**

# TAXPAYER MIGRATION

## EXPLANATORY NOTES

ITR
600(*c*)

Subsection 220(3.2) of the *Income Tax Act* allows the Minister of National Revenue to extend the time for the filing of, or allow the amendment or revocation of, certain elections under the Act and *Income Tax Regulations*. The list of those elections, in Part VI of the Regulations, is amended to include the elections contemplated by new paragraphs 128.1(6)(*a*) and (*c*) and (7)(*c*) of the Act. This amendment applies after October 1, 1996.

ITR
2606

Part XXVI of the Regulations sets out rules for computing an individual's income earned in a taxation year in a particular province.

Subsection 2606(1) of the Regulations provides for an adjustment to an individual's income earned in a particular province where the sum of the individual's incomes earned in each province and in countries other than Canada exceeds the individual's income for the year. Subsection 2606(2) of the Regulations provides a further adjustment for the purposes of subsection (1) where the individual is non-resident for part of a taxation year only.

Subsection 2606(2) of the Regulations is amended, with application to the 1998 and subsequent taxation years, to reflect amendments to section 114 of the Act (see the commentary on section 114 for further details). In addition, subsections 2606(1) and (2) are amended to update their language.

# APPENDIX C

## DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTE

### Capital Cost Allowance

**1. Subsection 1100(1) of the *Income Tax Regulations* is amended by adding the following after paragraph (*z*.1b):**

(*z*.1c) where throughout the taxation year the taxpayer was a common carrier that owned and operated a railway, such additional amount as the taxpayer may claim in respect of property for which a separate class is prescribed by subsection 1101(5d.2), not exceeding 6% of the undepreciated capital cost to the taxpayer of property of that class as of the end of the year (before making any deduction under this subsection for the year);

**2. (1) Subsection 1101 (5d.1) of the Regulations is replaced by the following:**

(5d.1) A separate class is hereby prescribed for all property included in Class 35 in Schedule II acquired at a time after December 6, 1991 and before February 28, 2000 by a taxpayer that was at that time a common carrier that owned and operated a railway.

(5d.2) A separate class is hereby prescribed for all property included in Class 35 in Schedule II acquired at a time after February 27, 2000 by a taxpayer that was at that time a common carrier that owned and operated a railway.

**(2) Subsection 1101(5q) of the Regulations is replaced by the following:**

(5q) Each of subsections (5p) and (5s) applies to a property or properties of a taxpayer only if the taxpayer has (by letter attached to the taxpayer's return of income filed with the Minister in accordance with section 150 of the Act for the taxation year in which the property or properties were acquired) elected that the subsection apply to the property or properties, as the case may be.

**(3) Section 1101 of the Regulations is amended by adding the following after subsection (5r):**

### *Manufacturing or Processing Property*

(5s) Subject to subsection (5q), a separate class is prescribed for one or more properties of a taxpayer

(*a*) that were acquired in a taxation year and included in the year in Class 43 in Schedule II because of paragraph (*a*) of that Class; and

(*b*) that had a capital cost to the taxpayer of at least $1,000.

### *Combustion Turbines*

(5t) A separate class is prescribed for one or more properties of a taxpayer that is a combustion turbine (including associated burners and compressors) included in Class 17 in Schedule II because of subparagraph (*a*.1)(*i*) of that Class if the taxpayer has (by letter attached to the taxpayer's return of income filed with the Minister in accordance with section 150 of the Act for the taxation year in which the property or properties were acquired) elected that this subsection apply to the property or properties.

**3. (1) The heading before subsection 1103(2g) of the Regulations is replaced by the following:**

### *Transfers to Class 8, Class 10 or Class 43*

**(2) Section 1103 of the Regulations is amended by adding the following after subsection (2h):**

### *Election to Include Properties in Class 35*

(2i) In respect of any property otherwise included in Class 7 in Schedule II because of paragraph (*h*) of that Class and to which paragraph 1100(1)(*z*.1a) and subsection 1101(5d), or paragraph 1100(1)(*z*.1c) and subsection 1101(5d.2), would apply if Class 35 of that Schedule applied to the property, the taxpayer may (by letter attached to the taxpayer's return of income filed with the Minister in accordance with section 150 of the Act for the taxation year in which the property is acquired) elect to include the property in Class 35 rather than in Class 7.

**4. Section 1104 of the Regulations is amended by adding the following after subsection (14):**

(15) For the purpose of subsection (14), a taxpayer's system referred to in that subsection that has at any particular time operated in the manner required by paragraph (*c*) of Class 43.1 in Schedule II includes at any time after the particular time a property of another person or partnership if

(*a*) the property, if it were owned by the taxpayer, would reasonably be considered to be part of the taxpayer's system;

(*b*) the property utilizes steam obtained from the taxpayer's system primarily in an industrial process (other than the generation of electrical energy);

(*c*) the operation of the property is necessary for the taxpayer's system to operate in the manner required by paragraph (*c*) of Class 43.1; and

(*d*) at the time that the taxpayer's system first became operational, the deficiency, failing or shutdown in the operation of the property could not reasonably have been anticipated by the taxpayer to occur within five years after that time.

**5. Paragraph 4600(2)(*k*) of the Regulations is replaced by the following:**

(*k*) property included in any of Class 21, 24, 27, 29, 34, 39, 40 or 43 in Schedule II or in Class 43.1 in that Schedule because of paragraph (*c*) of that Class; or

**6. Paragraph (*q*) of Class 1 in Schedule II to the Regulations is replaced by the following:**

(*q*) a building or other structure, or a part of it, including any component parts such as electric wiring, plumbing, sprinkler systems, air-conditioning equipment, heating equipment, lighting fixtures, elevators and escalators (except property described in any of paragraphs (*k*) and (*m*) to (*p*) or in any of paragraphs (*a*) to (*e*) of Class 8).

**7. Class 7 in Schedule II to the Regulations is amended by striking out the word "or" at the end of paragraph (*f*) and by adding the following after paragraph (*g*):**

(*h*) subject to an election made under subsection 1103(2i), property acquired after February 27, 2000 that is

(i) a rail suspension device designed to carry trailers that are designed to be hauled on both highways and railway tracks, or

(ii) a railway car; or

(*i*) property acquired after February 27, 2000 that is a railway locomotive, but not including an automotive railway car.

**8. The portion of Class 8 in Schedule II to the Regulations before paragraph (*a*) is replaced by the following:**

*CLASS 8*

Property not included in Class 1, 2, 7, 9, 11, 17 or 30 that is

**9. Class 17 in Schedule II to the Regulations is amended by adding the word "or" at the end of paragraph (*a*) and by adding the following after paragraph (*a*):**

(a.1) property (other than a building or other structure) acquired after February 27, 2000 that has not been used for any purpose whatever before it was acquired by the taxpayer and that is

(i) electrical generating equipment (other than electrical generating equipment described in any of paragraphs (*f*) to (*h*) of Class 8), or

(ii) production and distribution equipment of a distributor of water or steam used for heating or cooling (including, for this purpose, pipe used to collect or distribute an energy transfer medium but not including equipment or pipe used to distribute water that is for consumption, disposal or treatment),

**10. The portion of Class 43.1 in Schedule II to the Regulations before paragraph (*a*) is replaced by the following:**

*CLASS 43.1*

Property, other than reconditioned or remanufactured equipment, that would otherwise be included in Class 1, 2 or 8 or in Class 17 because of subparagraph (*a*.1)(i) of that Class

### *Application*

**11. (1) Subject to section 13, sections 1 to 3 and 7 to 10 apply to property acquired after February 27, 2000, except that subsections 1101(5s) and (5t) of the Regulations, as enacted by subsection 2(3), apply in respect of property**

**(*a*) acquired by a taxpayer after February 27, 2000 and in a taxation year ending on or before the day of the publication of these Regulations in Part II of the *Canada Gazette*; and**

**(*b*) in respect of which the taxpayer has elected, in a letter filed with the Minister, before the end of the sixth calendar month beginning after the month in which these Regulations are so published.**

**(2) Sections 4 and 5 apply to property acquired after February 21, 1994.**

**(3) Section 6 applies to property acquired after 1987.**

**12. For the purpose of subsection 1103(2g) of the *Income Tax Regulations*, an election that is in respect of property described in subsection 1101(5s) of the Regulations and that is made under paragraph 11(1)(*b*) of the present regulations is deemed to have been made in accordance with subsection 1101(5q) of the *Income Tax Regulations*.**

# CAPITAL COST ALLOWANCE

## EXPLANATORY NOTE

ITR

1100(1)(z.1c)

New paragraph 1100(1)(z.1c) of the *Income Tax Regulations* (the "Regulations") provides an additional 6% capital cost allowance ("CCA") deduction for railway property of a common carrier that owns and operates a railway and that is included in a separate Class 35 (7% CCA rate) because of new subsection 1101(5d.2). This additional CCA allowance is consequential to changes to the CCA rate applicable to certain railway assets more fully described below in the commentary to new subsection 1103(2i) and amended Class 7 (15% CCA rate). This change applies to property acquired after February 27, 2000.

ITR
1101(5d.1), 1101(5d.2),
1101(5q), 1101(5s) and 1101(5t)

Section 1101 of the Regulations prescribes separate classes of property in certain cases.

Subsection 1101(5d.1) is replaced by new subsection 1101(5d.2), which prescribes a separate class for all property included in Class 35 (7% CCA rate) acquired after February 27, 2000 by a taxpayer that was at that time a common carrier that owned and operated a railway. The replacement of subsection 1101(5d.1) with subsection 1101(5d.2) is consequential to changes to the CCA rate applicable to certain railway assets more fully described below in the commentary to new subsection 1103(2i) and amended Class 7 (15% CCA rate).

Subsection 1101(5q) allows a taxpayer to elect to have a separate class for rapidly depreciating electronic equipment. Subsection 1101(5q) is amended consequential to new subsection 1101(5s), which is described below.

New subsection 1101(5s) prescribes a separate class for one or more properties acquired by a taxpayer in a taxation year where the property is described in paragraph (*a*) of Class 43, the property is acquired after February 27, 2000, the property has a cost of at least $1,000 and the taxpayer has elected under subsection (5q) that the separate class apply. It should also be noted that subsection 1103(2g) provides that the undepreciated capital cost ("UCC") in respect of each such separate class election that is remaining after five years is to be transferred to the general Class 43 UCC pool.

New subsection 1101(5t) prescribes a separate class election for one or more properties acquired by a taxpayer in a taxation year that is a new combustion turbine (including associated burners and compressors) that generates electricity and to which Class 17 (8% CCA rate) applies.

These amendments apply to property acquired after February 27, 2000.

ITR
1103(2i)

New subsection 1103(2i) is consequential to new paragraph (*h*) of Class 7 (15% CCA rate) and provides an election under which a taxpayer may include certain railway assets in Class 35 (7% CCA rate) rather than in Class 7. This election may be made only in respect of railway cars and railway suspension devices described in paragraph (*h*) of Class 7 that are acquired after February 27, 2000. Further, such property only qualifies to be placed in Class 35 under this election if the property would have been eligible for an additional 6% CCA allowance under paragraph 1100(1)(*z*.1a) and subsection 1101(5d), or paragraph 1100(1)(*z*.1c) and subsection 1101(5d.2), if Class 35 had applied to the property. While property to which subsection 1103(2i) applies is eligible for a combined CCA rate of 13% (7% + 6%) rather than the 15% CCA rate available to Class 7 property, such property is "exempt property" for the purposes of the specified leasing property rules in subsection 1100(1.13) of the Regulations.

ITR
1104(14) and (15)

Generally, subsection 1104(14) of the Regulations provides that certain property (which is part of a system that was operated at a time within the parameters set out in paragraph (*c*) of Class 43.1 (30% CCA rate)) will continue to be considered to so operate during a period of a deficiency, failing or shutdown of the system that is beyond the control of the taxpayer. In such circumstances, the taxpayer is required to make all reasonable efforts to rectify the difficulty causing the deficiency, failing or shutdown within a reasonable period of time.

Concern has been expressed that the reference in subsection 1104(14) to a taxpayer's "system" does not include property of another taxpayer that provides a steam host, which is necessary for the taxpayer's system to operate in the manner required by Class 43.1. Thus, in cases where a taxpayer's system is not operating in the manner required under Class 43.1 because of a deficiency, failing or shutdown of the steam host's operation, subsection 1104(14) does not apply even if the taxpayer makes all reasonable efforts to have the deficiency rectified within a reasonable time.

New subsection 1104(15) provides that the reference in subsection 1104(14) to a taxpayer's system that was previously operated in the manner required by paragraph (*c*) of Class 43.1 includes the related property of another person or partnership if

- the property, if it were owned by the taxpayer, would reasonably be considered to be part of the taxpayer's system,

- the property utilizes steam obtained from the taxpayer's system primarily in an industrial process (other than the generation of electrical energy),

- the operation of the property is necessary for the taxpayer's system to operate in the manner required by paragraph (*c*) of Class 43.1, and

- at the time that the taxpayer's system first became operational, the deficiency, failing or shutdown in the operation of the property could not reasonably have been anticipated by the taxpayer to occur within five years after that time.

This relieving amendment applies to property acquired after February 21, 1994.

ITR
4600(2)(*k*)

Subsection 4600(2) of the Regulations indicates which type of property is "prescribed machinery and equipment" for the purposes in the definition "qualified property" in subsection 127(9) of the *Income Tax Act*, which concerns the investment tax credit regime. Paragraph 4600(2)(*k*) is amended to apply to property included in Class 43.1 because of paragraph (*c*) of that Class. Property included in Class 43.1 because of paragraph (*c*) of that Class could be eligible for investment tax credit treatment if certain conditions described in paragraph (*c*.1) of the definition "qualified property" in subsection 127(9) of the *Income Tax Act* are met.

This relieving change is consequential to the 1994 Budget measures that concerned electrical generating equipment referred to in paragraph (*c*) of Class 43.1. This amendment applies to property acquired after February 21, 1994.

ITR
Class 1, Schedule II

Paragraph (*q*) of Class 1 in Schedule II to the Regulations (4% CCA rate) applies to a building or structure, or component parts thereof.

Concern has been expressed that Class 8 (20% CCA rate) may not apply to certain buildings, structures, or component parts – described in paragraphs (*a*) to (*e*) of Class 8 – if Class 1 applies to such property because of paragraph (*q*) of that Class. To clarify that paragraph (*q*) of Class 1 does not apply to a property if any of paragraphs (*a*) to (*e*) of Class 8 apply to the property, paragraph (*q*) of Class 1 is amended to exclude structures, buildings or equipment referred to in paragraphs (*a*) to (*e*) of Class 8. Consequential to this change, paragraph (*q*) of Class 1 is also amended to exclude from its application property described in certain other paragraphs of Class 1.

This relieving amendment is applicable to property acquired after 1987.

ITR
Class 7, Schedule II

Class 7 (15% CCA rate) is amended to apply to certain railway property acquired after February 27, 2000. Generally, Class 7 will apply to property that is a railway car, a railway locomotive (other than an automotive railway car) or a railway suspension device designed to carry trailers that are designed to be hauled on both highways and railway tracks. In certain cases, a taxpayer may be eligible to elect under new subsection 1103(2i) to include certain leased railway cars and railway suspension devices in Class 35 (7% CCA rate). Such taxpayers may be eligible to deduct an additional allowance of 6% in respect of such railway property and not have the specified leasing property rules apply to the railway property. New subsection 1103(2i) is more fully described in the commentary accompanying that change.

ITR
Class 8, Schedule II

Class 8 (20% CCA rate) is amended to exclude from its application Class 17 property. This amendment is consequential to the inclusion in Class 17 of certain property more fully described below in the commentary accompanying that change.

ITR
Class 17, Schedule II

Class 17 (8% CCA rate) is amended to apply to property (other than a building or other structure) acquired after February 27, 2000 that has not been used for any purpose whatever before it was acquired by the taxpayer and that is

- electrical generating equipment (other than electrical generating equipment described in any of paragraphs (*f*) to (*h*) of Class 8), or

- production and distribution equipment of a distributor of water or steam used for heating or cooling (including, for this purpose, pipe used to collect or distribute an energy transfer medium but not including equipment or pipe used to distribute water that is for consumption, disposal or treatment).

ITR
Class 43.1, Schedule II

Class 43.1 (30% CCA rate) is amended to allow it to apply to qualifying electrical generating equipment that would otherwise be Class 17 property because of subparagraph (*a*.1)(i) of Class 17. This amendment is consequential to the inclusion in Class 17 of certain property more fully described in the commentary accompanying that change.

# APPENDIX D

# DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

## Insurance Business Policy Reserves

**1. (1) The *Income Tax Regulations* are amended by replacing "net premium" with "premium paid by the policyholder" in the following provisions:**

**(*a*) the description of A in subsection 1400(3);**

**(*b*) paragraphs (*a*) and (*b*) of the description of B in subsection 1400(3);**

**(*c*) paragraph (*b*) of subsection 1401(1);**

**(*d*) the description of C in subsection 1404(3); and**

**(*e*) the definition "reinsurance commission" in subsection 1408(1);**

**(2) The definitions "acquisition costs" and "net premium for the policy" in subsection 1408(1) of the Regulations are repealed.**

**(3) Subsections (1) and (2) apply to the 2000 and subsequent taxation years and, where the taxpayer elects on or before the taxpayer's filing-due date for the taxation year in which the amendments to section 18 of the *Income Tax Act* (as released on Announcement Date) receives Royal Assent, to the taxpayer's 1998 and 1999 taxation years.**

# INSURANCE BUSINESS POLICY RESERVES

## EXPLANATORY NOTES

### Part XIV

Part XIV of the *Income Tax Regulations* provides rules in respect of insurance business policy reserves.

Part XIV is amended to replace the term "net premium" wherever it appears with the term "premium paid by the policyholder". The change is consequential to newly added subsection 18(9.02) of the Act which denies a deduction on a current basis of acquisition costs of insurance policies (other than a non-cancellable or guaranteed renewable accident and sickness insurance policy, or a life insurance policy that is not a group term life insurance policy that provides coverage for a period of 12 months or less). This amendment ensures that deductions in respect of policy reserves remain consistent with the tax treatment of policy acquisition costs.

This amendment applies to the 2000 and subsequent taxation years and, if a taxpayer files an election in respect of amended subparagraph 18(9)(*a*)(ii) and new subsection 18(9.02) of the Act, the amendment also applies to the taxpayer's 1998 and 1999 taxation years.

### ITR 1408(1)

Subsection 1408(1) of the Regulations defines the term "acquisition costs" to mean a percentage of the premium paid for the policy. The percentages (either 20% or 5%) were based on assumptions relating to the average industry costs for selling, or otherwise distributing, insurance policies. The definition "acquisition costs" is repealed. The change addresses the insurance industry's concern that amounts deemed incurred as acquisition costs (generally 20% of premiums) under the old definition no longer reflect the real acquisition costs being incurred by insurers.

The definition "net premium for the policy" in subsection 1408(1) is also repealed. The definition is repealed because Part XIV no longer determines any amount on the basis of the unearned portion of a net premium for a policy.

This amendment applies to the 2000 and subsequent taxation years and, if a taxpayer files an election in respect of amended subparagraph 18(9)(*a*)(ii) and new subsection 18(9.02) of the Act, the amendment also applies to the taxpayer's 1998 and 1999 taxation years.

# APPENDIX E

## DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

### Foreign Property

**1. (1) Subsection 5000(7) of the *Income Tax Regulations* is amended by adding the following in alphabetical order:**

"cost amount" has the meaning assigned by section 206 of the Act;

**(2) Subsection (1) applies to months that end after February 2001.**

# FOREIGN PROPERTY

## EXPLANATORY NOTE

Interests in trusts and partnerships are treated, except as exempted by regulation, as foreign property for the purposes of the foreign property limit for deferred income plans. Part 50 of the *Income Tax Regulations* prescribes interests in certain trusts and partnerships as exempt for this purpose. Subsection 5000(7) of the Regulations is amended to provide that the definition "cost amount" in subsection 206(1) of the *Income Tax Act* applies for the purposes of Part 50 of the Regulations. This amendment is consequential to the introduction of that definition in subsection 206(1) of the Act. This amendment applies to months that end after February 2001.

# APPENDIX F

## DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

### Foreign Affiliates – Partnerships

**1. (1) The portion of subsection 5900(2) of the *Income Tax Regulations* before paragraph (*a*) is replaced by the following:**

(2) Notwithstanding paragraphs (1)(*a*) and (*b*), where at any time a foreign affiliate of a corporation resident in Canada pays a dividend on a share of a class of its capital stock (other than a dividend referred to in subsection 93(1) or (1.2) of the Act) to the corporation, the corporation may, in its return of income under Part I of the Act for its taxation year in which the dividend was received by it, designate an amount not exceeding the portion of the dividend received that would, but for this subsection, be prescribed to have been paid out of the affiliate's exempt surplus in respect of the corporation and that amount

**(2) Subsection 5900(3) of the Regulations is replaced by the following:**

(3) For the purpose of subsection 91(5) of the Act, where at any time a person (other than a corporation) resident in Canada receives a dividend on a share of any class of the capital stock of a foreign affiliate of that person, the affiliate is deemed to have an amount of taxable surplus in respect of the person and the portion of the dividend paid out of the taxable surplus of the affiliate in respect of the person is prescribed to be an amount equal to the dividend received.

**2. (1) The portion of subsection 5902(1) of the Regulations before paragraph (*a*) is replaced by the following:**

Election in respect
of capital gains

(1) Where at any time a dividend is, because of an election made under subsection 93(1) or (1.2) of the Act in respect of a disposition,

deemed to have been received on one or more shares of a class of the capital stock of a particular foreign affiliate of a corporation resident in Canada, the following rules apply:

**(2) The portion of subparagraph 5902(1)(*c*)(ii) of the Regulations before clause (A) is replaced by the following:**

> (ii) the particular affiliate is deemed to have paid a whole dividend at that time on the shares of that class of its capital stock in an amount equal to the product obtained when the total of amounts so deemed by subsection 93(1) or (1.2) of the Act to have been received as dividends on shares of that class is multiplied by the greater of

**(3) Subsection 5902(3) of the Regulations is replaced by the following:**

(3) Where an election under subsection 93(1) or (1.2) of the Act is made by a corporation resident in Canada in respect of the disposition of a share of the capital stock of a foreign affiliate of the corporation, no adjustment shall be made to the affiliate's exempt surplus, exempt deficit, taxable surplus, taxable deficit or underlying foreign tax in respect of the corporation as a consequence of the election except as provided in subsections 5905(2), (5) and (8).

**(4) Subsection 5902(5) of the Regulations is replaced by the following:**

(5) Any election under subsection 93(1) or (1.2) of the Act by a corporation resident in Canada in respect of any share of the capital stock of a foreign affiliate of the corporation disposed of by it, by a foreign affiliate of the corporation or by a partnership shall be made by filing the prescribed form with the Minister on or before the day that is,

> (*a*) where the election is made in respect of a share disposed of by the corporation, the corporation's filing-due date for its taxation year in which the disposition was made;
>
> (*b*) where the election is made in respect of a share disposed of by a foreign affiliate of the corporation, the corporation's filing-due date for its taxation year in which the taxation

year of the foreign affiliate in which the disposition was made ends; and

(*c*) where the election is made in respect of a share disposed of by a partnership, and

(i) the disposing corporation referred to in subsection 93(1.2) of the Act is the corporation, the corporation's filing-due date for its taxation year in which the fiscal period of the partnership in which the disposition was made ends, or

(ii) the disposing corporation referred to in subsection 93(1.2) of the Act is a foreign affiliate of the corporation, the corporation's filing-due date for its taxation year in which the taxation year of the foreign affiliate which includes the last day of the fiscal period of the partnership in which the disposition was made ends.

**(5) Subsection 5902(6) of the Regulations is replaced by the following:**

(6) Where at any time a corporation resident in Canada is deemed by of subsection 93(1.1) or (1.3) of the Act to have made an election under subsection 93(1) or (1.2) of the Act in respect of a share of the capital stock of a particular foreign affiliate of the corporation disposed of by a foreign affiliate of the corporation or by a partnership, the amount deemed to have been designated in the election is prescribed to be the lesser of

(*a*) the capital gain (or where subsection 93(1.2) of the Act applies, the taxable capital gain), if any, otherwise determined in respect of the disposition of the share; and

(*b*) the amount (or where subsection 93(1.2) of the Act applies, 3/4 of the amount) that could reasonably be expected to have been received in respect of the share if the particular affiliate had at that time paid dividends the aggregate of which on all shares of its capital stock was equal to the amount determined under paragraph 1(*a*) to be its net surplus in respect of the corporation for the purposes of the election.

**3. (1) The portion of paragraph 5905(2)(*a*) of the Regulations before subparagraph (i) is replaced by the following:**

> (*a*) where, because of an election made by the corporation under subsection 93(1) or (1.2) of the Act, a dividend is deemed to have been received on one or more of the shares of the foreign affiliate that were disposed of by the corporation or by another foreign affiliate of the corporation (in this paragraph referred to as the "transferor") because of the redemption, acquisition or cancellation of such share or shares by the foreign affiliate, for the purposes of the adjustment required by paragraph (*b*),

**(2) Paragraph 5905(6)(*a*) of the Regulations is replaced by the following:**

> (*a*) where paragraph (5)(*a*) applies and the predecessor corporation is, because of an election made under subsection 93(1) or (1.2) of the Act, deemed to have received a dividend on one or more of the shares of the particular affiliate disposed of in the transaction, for the purposes of the adjustment required by paragraph (*b*),

**(3) The portion of subsection 5905(8) of the Regulations before paragraph (*a*) is replaced by the following:**

(8) Where at any time a dividend is, because of an election made by a corporation under subsection 93(1) or (1.2) of the Act, deemed to have been received on one or more shares of a class of the capital stock of a particular foreign affiliate of the corporation disposed of to the corporation or to another corporation that was a foreign affiliate of the corporation immediately after the disposition, the following rules apply:

**(4) Section 5905 of the Regulations is amended by adding the following after subsection (13):**

(14) For the purpose of this section, where the number of shares of a class of the capital of the capital stock of a foreign affiliate of a corporation resident in Canada deemed by subsection 93.1(1) of the Act to be owned by a person at a particular time is different from the number so deemed immediately before the particular time

(*a*) if the number of shares of that class deemed to be owned by the person has decreased, the person is deemed to have disposed of, at the particular time, the number of shares of that class equal to the amount of the decrease;

(*b*) if the number of shares of that class deemed to be owned by the person has increased, the person is deemed to have acquired, at the particular time, the number of shares of that class equal to the amount of the increase;

(*c*) a person (in this paragraph referred to as the "seller") that is deemed by paragraph (*a*) to have disposed of, at a particular time, shares of a class is deemed to have disposed of those shares to the persons (in this paragraph referred to as the "acquirers") deemed in paragraph (*b*) to have acquired shares of that class at that time and the number of shares of that class deemed to have been acquired at that time by a particular acquirer from the seller shall be determined by the formula

$$A(B/C)$$

where

A is the number of shares of that class acquired by the particular acquirer at that time,

B is the number of shares of that class disposed of by the seller at that time, and

C is the number of shares of that class acquired by all acquirers at that time; and

(*d*) persons (in this paragraph referred to as the "acquirers") that are deemed by paragraph (*b*) to have acquired, at a particular time, shares of a class are deemed to have acquired those shares from a person (in this paragraph referred to as the "seller") deemed in paragraph (*a*) to have disposed of shares of that class at that time and the number of shares of that class deemed to have been disposed of by the seller to a particular acquirer at that time shall be determined by the formula

$$A(B/C)$$

where

A is the number of shares of that class disposed of by the seller,

B is the number of shares of that class acquired by the particular acquirer at that time, and

C is the number of shares of that class time disposed of by all sellers at that time.

(15) In determining,

(*a*) for the purpose of this Part (other than section 5904), the equity percentage at any time of a person in a corporation,

(*b*) for the purpose of this section, the surplus entitlement at any time of a share owned by a corporation resident in Canada of the capital stock of a foreign affiliate of the corporation in respect of a particular foreign affiliate of the corporation, and

(*c*) for the purposes of this Part and of the definition "surplus entitlement percentage" in subsection 95(1) of the Act, the surplus entitlement percentage at any time of a corporation resident in Canada in respect of a particular foreign affiliate of the corporation,

where at any time shares of a class of the capital stock of a corporation are owned by a partnership or are deemed under this subsection to be owned by a partnership, those shares are deemed to be owned at that time by each member of the partnership in a proportion equal to the proportion of all such shares that

(*d*) the fair market value of the member's interests in the partnership at that time

is of

(*e*) the fair market value of all members' interest in the partnership at that time.

**4. (1) Section 1 applies to dividends received after November 1999.**

**(2) Section 2 applies to dispositions that occur after November 1999.**

**(3) Section 3 applies after November 1999.**

# FOREIGN AFFILIATES – PARTNERSHIPS

## EXPLANATORY NOTES

ITR
5900(2)

Subsection 5900(2) of the *Income Tax Regulations* allows a corporation resident in Canada to elect to have a dividend paid by a foreign affiliate of the corporation to be treated as having been paid out of the taxable surplus rather than out of the exempt surplus of the affiliate. This election is not available where the corporation has elected under subsection 93(1) of the Act to treat proceeds of disposition of a share of a foreign affiliate as a dividend. The amendment ensures that the election in subsection 5900(2) will not apply where the corporation has elected under new subsection 93(1.2) of the Act to treat all or a portion of its gain from a partnership arising on the disposition of a share of a foreign affiliate by the partnership as a dividend.

This amendment applies to dividends received after November 1999.

ITR
5900(3)

Subsection 5900(3) of the Regulations applies where an individual resident in Canada receives a dividend from a foreign affiliate. For the purpose of subsection 91(5) of the Act, subsection 5900(3) deems the individual to have received all dividends out of the taxable surplus of the affiliate. Subsection 91(5) of the Act permits deductions in respect of dividends paid out of the taxable surplus of an affiliate to the extent that that surplus is represented by foreign accrual property income of the affiliate that has been taxed in the hands of the dividend recipient.

The amendment to subsection 5900(3) replaces the word "individual" with the phrase "person (other than a corporation)". This amendment clarifies that, for the purpose of subsection 91(5), where a partnership is deemed to be a person under section 96 of the Act the partnership is deemed to have received all dividends out of taxable surplus.

This amendment applies to dividends received after November 1999.

### Election in respect of Capital Gains

ITR
5902(1)

Section 5902 of the Regulations applies where a corporation elects to treat proceeds of disposition of a share of a foreign affiliate as a dividend under subsection 93(1) of the Act. Subsection 5902(1) computes a foreign affiliate's surplus accounts and the amount of a whole dividend used in applying subsection 5901(1) for the purposes of subsection 5900(1) of the Regulations. The amendment to subsection 5902(1) ensures that the subsection will also apply where the corporation resident in Canada has elected under new subsection 93(1.2) of the Act to treat a gain from a partnership arising on the disposition of a share of a foreign affiliate of the corporation by the partnership as a dividend.

This amendment applies to dispositions that occur after November 1999.

ITR
5902(3)

Subsection 5902(3) of the Regulations indicates that where an election is made under subsection 93(1) of the Act, no adjustment shall be made to the affiliate's exempt surplus, exempt deficit, taxable surplus, taxable deficit or underlying foreign tax in respect of the corporation as a consequence of the election except as provided in subsections 5905(2), (5) and (8). The amendment to subsection 5902(3) extends the application of the provision to elections made under new subsection 93(1.2) of the Act.

This amendment applies to dispositions that occur after November 1999.

ITR
5902(5)

Subsection 5902(5) of the Regulations provides that any election under subsection 93(1) of the Act must be made by filing the prescribed form by the corporation's filing-due date for the relevant year. Where the disposition is made by the corporation, the relevant year is the taxation year of the corporation in which the disposition was made. Where the disposition is made by a foreign affiliate of the corporation, the relevant year is the taxation year of the corporation in which the taxation year of the foreign affiliate in which the disposition was made ends.

The amendments to subsection 5902(5) extend its application to include elections made under new subsection 93(1.2) of the Act. Where the disposition is made by a partnership, the relevant year depends on whether the "disposing corporation" in subsection 93(1.2) of the Act is the corporation or a foreign affiliate of the corporation. Where the disposing corporation is the corporation, the relevant year is the taxation year of the corporation in which the fiscal period of the partnership in which the disposition was made ends. Where the disposing corporation is a foreign affiliate of the corporation, the relevant year is the taxation year of the corporation in which the taxation year of the affiliate which includes the last day of the fiscal period of the partnership in which the disposition was made ends.

This amendment applies to dispositions that occur after November 1999.

ITR
5902(6)

Subsection 5902(6) of the Regulations applies where subsection 93(1.1) of the Act deems a corporation to have made an election under subsection 93(1) to treat proceeds of disposition of a share of a foreign affiliate as a dividend. Subsection 5902(6) deems the amount designated in the deemed election to be the lesser of the capital gain otherwise determined in respect of the disposition of the share and the amount that could reasonably be expected to have been received on the share if the affiliate had paid its net surplus in respect of the corporation as a dividend.

Subsection 5902(6) is amended to ensure that the subsection will apply where new subsection 93(1.3) of the Act deems a corporation resident in Canada to have made an election under proposed subsection 93(1.2) of the Act in respect of a taxable capital gain from a deemed disposition of a share of a foreign affiliate of the corporation disposed of by a partnership of which another foreign affiliate of the corporation is a member.

This amendment applies to dispositions that occur after November 1999.

ITR
5905(2)

Subsection 5905(2) of the Regulations applies where shares of a foreign affiliate of a corporation resident in Canada are redeemed or cancelled (otherwise than by way of a winding-up). If the corporation has made an election under subsection 93(1) of the Act or if the corporation's surplus entitlement percentage in the affiliate changes, then the affiliate's surplus balances are adjusted to offset the change in the surplus entitlement percentage. The amendments to subsection 5905(2) ensure that the subsection will also apply where an election is made under subsection 93(1.2) of the Act.

These amendments apply after November 1999.

ITR
5905(6)(*a*)

Paragraph 5905(6)(*a*) of the Regulations applies for the purpose of paragraph 5905(5)(*a*) to adjust the surplus balances of a particular foreign affiliate of a corporation resident in Canada where the corporation has made an election under subsection 93(1) of the Act. The amendment to paragraph 5905(6)(*a*) ensures that the paragraph will also apply where the corporation has made an election under new subsection 93(1.2) of the Act.

This amendment applies after November 1999.

ITR
5905(8)

Subsection 5905(8) of the Regulations reduces the surplus accounts of a particular foreign affiliate of a corporation resident in Canada where a dividend is deemed to have been received from the particular affiliate following an election under subsection 93(1) of the Act. The amendment to subsection 5905(8) ensures that the subsection will also apply where a dividend is deemed to have been received from the particular affiliate following an election under new subsection 93(1.2) of the Act.

This amendment applies after November 1999.

ITR
5905(14)

New subsection 93.1(1) of the Act deems, for certain purposes, a member of a partnership to own its proportionate number of shares of a non-resident corporation held by a partnership. New subsection 5905(14) of the Regulations applies where the number of shares of a foreign affiliate of a corporation resident in Canada deemed to be owned by a person under subsection 93.1(1) increases or decreases.

Where the number of shares deemed to be held by the person has decreased, the person is deemed to have disposed of shares to the extent of the decrease. Where the number of shares deemed to be held by the person has increased, the person is deemed to have acquired shares to the extent of the increase. Persons that are treated as having acquired shares of class are treated as having acquired those shares proportionately from persons that are treated as having disposed of shares of that class and vice versa.

New subsection 5905(14) applies after November 1999.

ITR
5905(15)

New subsection 5905(15) of the Regulations applies to determine the equity percentage (other than for section 5904), surplus entitlement of a share and the surplus entitlement percentage at any time of a corporation resident in Canada in respect of a particular foreign affiliate of the corporation where the shares of the foreign affiliate are property of a partnership. Each member of the partnership is deemed to own that proportion of the number of the shares held by the partnership that the fair market value of the member's interest in the partnership is of the fair market value of all the members' interests in the partnership.

New subsection 5905(15) applies after November 1999.

# APPENDIX G

## DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

### Foreign Affiliates – FAPI

**1. (1) Section 5903 of the *Income Tax Regulations* is replaced by the following:**

**5903.** (1) For the purpose of the description of F in the definition "foreign accrual property income" in subsection 95(1) of the Act, the deductible loss of a foreign affiliate of a taxpayer for a particular taxation year of the affiliate is the amount claimed by the taxpayer not exceeding the foreign accrual property loss of the affiliate for the seven taxation years of the affiliate preceding and the three taxation years of the affiliate following the particular year.

(2) In determining the deductible loss of a foreign affiliate of a taxpayer for a particular taxation year of the affiliate

(*a*) the amount claimed under subsection (1) in respect of a foreign accrual property loss of the affiliate for a taxation year of the affiliate shall not exceed the amount by which that loss exceeds the total of all amounts each of which was an amount claimed by any taxpayer in respect of that loss in computing the deductible loss of the affiliate for taxation years of the affiliate before the particular year; and

(*b*) no amount may be claimed in respect of a foreign accrual property loss of a foreign affiliate for a taxation year of the affiliate until the foreign accrual property losses of the affiliate for preceding taxation years have been fully claimed.

(3) For the purpose of this section, and subject to subsection (4), "foreign accrual property loss" of a foreign affiliate of a taxpayer for a taxation year means

(a) where at the end of the year the foreign affiliate was a controlled foreign affiliate of the taxpayer, the amount, if any, by which

(i) the total of the amounts determined for D and E in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of the affiliate for the year

exceeds

(ii) the total of the amounts determined for A, B, and C in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of the affiliate for the year, or

(b) where, at the end of the year, the foreign affiliate was not a controlled foreign affiliate of the taxpayer but was a controlled foreign affiliate of a person described in any of subparagraphs 95(2)(*f*)(iv) to (vii) of the Act, the amount determined under paragraph (*a*) for the year.

(4) In computing the foreign accrual property loss of a particular foreign affiliate of a taxpayer for a taxation year of the affiliate, where the particular affiliate or another corporation has received a payment described in subsection 5907(1.3) from another foreign affiliate of the taxpayer which payment can reasonably be considered to relate to a loss or portion of a loss of the particular affiliate for the year described in the description of D or E of the definition "foreign accrual property income" in subsection 95(1) of the Act, the amount of the loss or portion of the loss for the year is deemed to be nil.

(5) For the purpose of this section, where there has been a foreign merger (within the meaning assigned by subsection 87(8.1) of the Act) of two or more foreign affiliates of a taxpayer resident in Canada in respect of each of which the taxpayer's surplus entitlement percentage immediately before the merger was not less than 90 percent (each of which is in this subsection referred to as a "predecessor affiliate") to form a new foreign affiliate in respect of which the taxpayer's surplus entitlement percentage immediately after the merger was not less than 90 percent (in this section referred to as the "successor affiliate"), the successor is deemed to be the same corporation as, and a continuation of, each predecessor affiliate.

(6) For the purpose of this section, where there has been a winding-up of one or more foreign affiliates of a taxpayer resident in Canada in respect of which the taxpayer's surplus entitlement percentage immediately before the winding-up was not less than

90 percent (each of which is in this subsection referred to as a "predecessor affiliate") into another foreign affiliate of the taxpayer in respect of which the taxpayer's surplus entitlement percentage immediately before and after the winding-up was not less than 90 percent (in this subsection referred to as the "successor affiliate"), the successor affiliate is deemed to be the same corporation as, and a continuation of, each predecessor affiliate.

**2. (1) The portion of subsection 5907(1.3) of the Regulations before paragraph (*a*) is replaced by the following:**

(1.3) For the purpose of paragraph (*b*) of the definition "foreign accrual tax" in subsection 95(1) of the Act and subject to subsection (1.4),

**(2) Section 5907 of the Regulations is amended by adding the following after subsection (1.3):**

(1.4) Any amount paid by a particular affiliate described in paragraph (1.3)(*a*) or (*b*) does not include any amount paid by the particular affiliate to any other corporation where the amount paid can reasonably be considered to be in respect of a loss of any other corporation and such loss would not be a foreign accrual property loss of the other corporation (as defined in subsection 5903(3)) without taking into account the particular payment.

**3. (1) Subsection (1) applies to taxation years of foreign affiliates that begin after 1998, except that paragraph 5903(2)(*b*) of the Regulations, as enacted by subsection (1), applies to foreign affiliate taxation years that begin after 2000.**

**(2) Section 2 applies to taxation years that begin after November 1999.**

# FOREIGN AFFILIATES – FAPI LOSSES

## EXPLANATORY NOTES

ITR
5903

The description of F in the definition "foreign accrual property income" in subsection 95(1) of the Act allows foreign accrual property income of an affiliate for a year to be reduced by the amount prescribed by section 5903 of the *Income Tax Regulations* to be the deductible loss of the affiliate for the year and the five immediately preceding taxation years. The amendments to section 5903 and the description of F in the definition "foreign accrual property income" in subsection 95(1) of the Act provide that deductible losses may include foreign accrual property losses for the three taxation years following and the seven taxation years preceding the year.

Amended subsection 5903(1) allows a taxpayer to include in the deductible loss of a foreign affiliate an amount not exceeding the foreign accrual property loss of the affiliate for the seven taxation years immediately preceding and the three taxation years immediately following the particular year. Losses for other taxation years will not be included in the deductible loss of the foreign affiliate.

Amended subsection 5903(2) of the Regulations provides that, in determining the deductible loss of a foreign affiliate of a taxpayer for a particular taxation year, the amount claimed under subsection 5903(1) in respect of a foreign accrual property loss of the affiliate for a taxation year of the affiliate cannot exceed the total of amounts previously claimed by any taxpayer in respect of that loss. Also, no amount may be claimed in respect of a foreign accrual property loss until the foreign accrual property loss for preceding taxation years has been fully claimed.

Amended subsection 5903(3) of the Regulations defines foreign accrual property loss of a foreign affiliate of a taxpayer for a taxation year. Where, at the end of a taxation year, a foreign affiliate is a controlled foreign affiliate of the taxpayer or a person related to the taxpayer, the foreign accrual property loss of the affiliate is the amount, if any, by which (D+E) exceeds (A+B+C) in the definition "foreign accrual property income" in subsection 95(1) of the Act.

New subsection 5903(4) of the Regulations provides that, where a foreign affiliate of a taxpayer received a payment described in subsection 5907(1.3) of the Regulations from another affiliate or another corporation, which payment was related to a loss or portion of a loss of the affiliate, the amount of the loss or portion of the loss for the year shall be deemed to be nil.

New subsections 5903(5) and (6) of the Regulations provides that a predecessor affiliate's deductible loss may flow through to a successor affiliate following a foreign merger or a winding-up of one or more affiliates of a taxpayer provided the taxpayer's surplus entitlement percentage exceeds 90 per cent in each predecessor affiliate and in the successor affiliate.

The amendments to section 5903 apply to taxation years of a foreign affiliate that begin after 1998, except that paragraph 5903(2)(*b*) of the Regulations applies to foreign affiliate taxation years that begin after 2000.

ITR
5907(1.3) and (1.4)

Subsection 91(4) of the Act provides for a deduction in the computation of a taxpayer's income in respect of foreign accrual tax that is attributable to an amount of foreign accrual property income included in the computation of the taxpayer's income. Subsection 95(1) of the Act defines foreign accrual tax to include amounts prescribed to be foreign accrual tax.

In circumstances where the loss of another corporation in a particular group of foreign affiliates of a taxpayer is relevant in the computation of the tax liability of the group to a foreign government, paragraphs 5907(1.3)(*a*) and (*b*) of the Regulations provides that an amount paid by the particular corporation to the other corporation in the group in respect of the use of a loss of any other corporation in the computation of the group's tax liability to the foreign government is foreign accrual tax. These provisions apply where the loss of the other corporation is an active business loss or a capital loss resulting from the disposition of excluded property as well as where the loss is a foreign accrual loss as defined in subsection 5903(3) of the Regulations. Subsection 5907(1.3), which applies to taxation years that begin after November 1999, is amended as a consequence of the introduction of subsection 5907(1.4) of the Regulations.

New subsection 5907(1.4) ensures that in such circumstances the amount paid by the particular affiliate to the other corporation will only be foreign accrual tax to the extent that the amount paid is in respect of a foreign accrual property loss of any other corporation. This is consistent with the fact that, under section 5903 of the Regulations, active business losses and capital losses resulting from the disposition of excluded property of a foreign affiliate of a taxpayer are not included in the computation of a deductible loss which may be used to reduce foreign accrual property income of that affiliate in a particular taxation year.

This amendment applies to taxation years that begin after November 1999.

# APPENDIX H

## DRAFT *INCOME TAX REGULATION* AND EXPLANATORY NOTE

### Capital Gains Deferral (Eligible Small Business Investments)

**1. (1) The portion of subsection 6204(1) of the *Income Tax Regulations* before paragraph (*a*) is replaced by the following:**

(1) For the purposes of paragraph 110(1)(d) and section 44.1 of the Act, a share is a prescribed share of the capital stock of a corporation at the time of its sale or issue, as the case may be, where, at that time,

**(2) Subsection (1) applies in respect of dispositions that occur after February 27, 2000.**

# CAPITAL GAINS DEFERRAL
## (ELIGIBLE SMALL BUSINESS INVESMENTS)

### EXPLANATORY NOTE

ITR
6204(1)

Subsection 6204(1) of the *Income Tax Regulations* prescribes a common share for the purposes of paragraph 110(1)(*d*) of the *Income Tax Act*. The subsection is amended to have it also apply for the purposes of section 44.1 of the Act.

## APPENDIX I

## DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

### Registered Pension Plans

**1. Paragraph 8300(8)(*a*) of the *Income Tax Regulations* is amended by striking out the word "or" at the end of subparagraph (ii), by striking out the word "and" at the end of subparagraph (iii), by adding the word "or" at the end of subparagraph (iii) and by adding the following after subparagraph (iii):**

> (iv) property transferred to the provision in respect of the surplus under another money purchase provision of the plan or under a money purchase provision of another registered pension plan, and

**2. Paragraph 8301(4)(*b*) of the Regulations is amended by striking out the word "or" at the end of subparagraph (ii), by adding the word "or" at the end of subparagraph (ii.1) and by adding the following after subparagraph (ii.1):**

> (ii.2) property transferred to the provision in respect of the surplus under another money purchase provision of the plan or under a money purchase provision of another registered pension plan,

**3. (1) Section 8500 of the Regulations is amended by adding the following after subsection (1):**

(1.1) The definition "surplus" in subsection (1) applies for the purpose of subsection 147.3(7.1) of the Act.

**(2) Subsection 8500(7) of the Regulations is amended by striking out the word "or" at the end of paragraph (*b*), by adding the word "or" at the end of paragraph (*c*) and by adding the following after paragraph (*c*):**

(*d*) property transferred to the provision in respect of the surplus under another money purchase provision of the plan or under a money purchase provision of another registered pension plan

**4. Section 8501 of the Regulations is amended by adding the following after subsection (6):**

Member contributions for unfunded liability

(6.1) For the purposes of the conditions in this Part, a contribution made by a member of a pension plan in respect of a defined benefit provision of the plan is deemed to be a current service contribution made by the member in respect of the member's benefits under the provision if

(*a*) the contribution cannot, but for this subsection, reasonably be considered to be made in respect of the member's benefits under the provision;

(*b*) the contribution is determined by reference to the actuarial liabilities under the provision in respect of periods before the time of the contribution; and

(*c*) the contribution is made pursuant to an arrangement

(i) under which all, or a significant number, of the active members of the plan are required to make similar contributions,

(ii) the main purpose of which is to ensure that the plan has sufficient assets to pay benefits under the provision, and

(iii) that is approved by the Minister.

Prescribed eligible contributions

(6.2) For the purpose of paragraph 147.2(4)(*a*) of the Act, a contribution described in subsection (6.1) is a prescribed eligible contribution.

**5. (1) Subparagraph 8502(*d*)(ii) of the Regulations is replaced by the following:**

> (ii) a transfer of property held in connection with the plan where the transfer is made in accordance with subsection 147.3(3), (4.1), (7.1) or (8) of the Act,

**(2) Paragraph 8502(*k*) of the Regulations is replaced by the following:**

Transfer of property
between provisions

> (*k*) property that is held in connection with a benefit provision of the plan is not made available to pay benefits under another benefit provision of the plan (including another benefit provision that replaces the first benefit provision), except where the transaction by which the property is made so available is such that if the benefit provisions were in separate registered pension plans, the transaction would constitute a transfer of property from one plan to the other in accordance with any of subsections 147.3(1) to (4.1), (6), (7.1) and (8) of the Act;

**6. (1) Section 1 and subsection 3(2) apply to allocations that occur after 1998.**

**(2) Section 2 applies to the determination of pension credits for 1999 and subsequent years.**

**(3) Subsection 3(1) applies after 1998.**

**(4) Section 4 applies to contributions made after 1990.**

**(5) Section 5 applies to transactions that occur after 1998.**

# REGISTERED PENSION PLANS

## EXPLANATORY NOTES

### Interpretation

ITR
8300(8)(*a*)

Subsection 8300(8) of the *Income Tax Regulations* deems certain amounts allocated to an individual under a money purchase provision of a registered pension plan (RPP) to be employer contributions for the purpose of Part LXXXIII of the Regulations. The subsection applies where

- the allocation is attributable to forfeitures or surplus under the money purchase provision, or to surplus transferred from a defined benefit provision, and
- the allocation is in lieu of an employer contribution.

Subsection 8300(8) will generally not affect the calculation of pension credits. However, it is relevant for the application of subsections 8308(5) and (6) (retroactive contributions in respect of a period of reduced services) and subsection 8308(7) (loaned employee rules).

Subsection 8300(8) is amended so that it also applies with respect to allocations that are attributable to money purchase surplus transferred from another money purchase provision. This amendment is consequential to the introduction of new subsection 147.3(7.1) of the Act, which permits the transfer of surplus from one money purchase plan to another. It should be noted that this amendment is relevant only where money purchase surplus is allocated to an individual at the time of the transfer. Existing subparagraph 8300(8)(*a*)(ii) would apply with respect to allocations that occur after the time of the transfer.

This amendment applies to allocations that occur after 1998.

**Pension credit – money purchase provision**

ITR
8301(4)(*b*)

In general terms, subsection 8301(4) of the Regulations defines the pension credit of an individual for a year in respect of an employer under a money purchase provision of a pension plan to be the total of

- contributions made in the year by the individual or by the employer with respect to the individual, and

- amounts allocated to the individual in the year that are attributable to forfeited amounts, to surplus under the provision or to surplus transferred from a defined benefit provision.

Paragraph 8301(4)(*b*) is amended to include in an individual's pension credit any amount allocated to the individual that is attributable to surplus transferred to the provision from another money purchase provision. This amendment is consequential to the introduction of subsection 147.3(7.1) of the Act, which permits the transfer of surplus from one money purchase plan to another. It should be noted that this amendment is relevant only where the money purchase surplus is allocated to an individual immediately upon being transferred. Where the allocation is made after the time of the transfer, existing subparagraph 8301(4)(*b*)(ii) would apply to include the allocated amount in the individual's pension credit.

It should also be noted that, where such an allocation is in lieu of an employer contribution, amended subsection 8300(8) deems the allocated amount to be an employer contribution rather than an amount attributable to surplus. Thus, the amount is included in the individual's pension credit as an employer contribution, and not as an allocation of surplus.

This amendment applies in determining pension credits for 1999 and subsequent years.

## Interpretation

ITR
8500(1.1)

New subsection 147.3(7.1) of the Act permits, in certain circumstances, surplus under a money purchase provision of an RPP to be transferred to a money purchase provision of another RPP. Subsection 147.3(7.1) provides that the term "surplus" has the meaning assigned by the Regulations. New subsection 8500(1.1) of the Regulations provides that the definition of "surplus" in subsection 8500(1) of the Regulations applies for this purpose.

This amendment applies after 1998.

ITR
8500(7)

Subsection 8500(7) of the Regulations deems certain amounts allocated to an individual under a money purchase provision of an RPP to be contributions made on behalf of the individual for the purposes of a number of provisions in Part LXXXV that depend on whether money purchase contributions are made on behalf of an individual. Subsection 8500(7) applies with respect to allocated amounts that are attributable to forfeited amounts, to surplus under the provision or to surplus transferred from a defined benefit provision.

Subsection 8500(7) is amended so that it also applies with respect to allocations that are attributable to money purchase surplus transferred from another money purchase provision. This amendment is consequential to the introduction of new subsection 147.3(7.1) of the Act, which permits the transfer of surplus from one money purchase plan to another. It should be noted that this amendment is relevant only where money purchase surplus is allocated to an individual at the time of the transfer. Existing paragraph 8500(7)(*b*) would apply with respect to allocations that occur after the time of the transfer.

This amendment applies to allocations that occur after 1998.

## Member contributions for unfunded liability

ITR
8501(6.1)

New subsection 8501(6.1) of the Regulations applies where member contributions under a defined benefit provision of a pension plan are made in respect of an unfunded liability, rather than in respect of the member's benefits. The purpose of this subsection is to accommodate arrangements under defined benefit pension plans that require participating employers and plan members to share in the funding of an unfunded liability.

Under some shared-funding arrangements, member contributions that are dedicated towards the plan's unfunded liability are not considered to be made in respect of the member's benefits. Subsection 8501(6.1) provides that, for the purposes of the conditions in Part LXXXV, such contributions are considered to be current service contributions made in respect of the member's benefits under the provision. This ensures that the contributions are not prohibited by the permissible contribution rule in paragraph 8502(*b*). It also requires that the contributions be taken into account for the purpose of satisfying the current service contribution limit in paragraph 8503(4)(*a*). It should be noted that subsection 8503(5) may be relevant where the member contribution rate under a shared funding arrangement is set a level that results in the condition in paragraph 8503(4)(*a*) not being met. Subsection 8503(5) allows the Minister to waive the condition on maximum member contributions where it is reasonable to expect, on a long-term basis, that the regular current service contributions made by members will fund no more than one-half of the related benefits.

New subsection 8501(6.1) applies where:

- member contributions under a defined benefit provision of a pension plan are determined by reference to the actuarial liabilities under the provision;

- the contributions cannot reasonably be considered to be in respect of the member's benefits;

- the contributions are made pursuant to an arrangement approved by the Minister that requires all or a significant number of the active members of the plan to make similar contributions; and

- the main purpose of the arrangement is to ensure that the plan is adequately funded.

Subsection 8501(6.1) applies to contributions made after 1990.

### Prescribed eligible contributions

ITR
8501(6.2)

New subsection 8501(6.2) of the Regulations provides that contributions described in subsection 8501(6.1) are prescribed eligible contributions for the purpose of the deductibility rules in amended paragraph 147.2(4)(*a*) of the Act. This ensures that member contributions made pursuant to a shared-funding arrangement are deductible even though they are not considered to relate to a particular year.

Subsection 8501(6.2) applies to contributions made after 1990.

### Permissible distributions

ITR
8502(*d*)

Paragraph 8502(*d*) of the Regulations restricts the distributions that may be made out of an RPP.

Paragraph 8502(*d*) is amended to add to the list of permissible distributions a transfer of property made in accordance with new subsection 147.3(7.1) of the Act. Subsection 147.3(7.1) permits the transfer of surplus from one money purchase plan to another, where the second plan replaces all or part of the first plan.

This amendment, which is consequential to the introduction of subsection 147.3(7.1), applies to transactions that occur after 1998.

## Transfer of property between provisions

ITR
8502(*k*)

Paragraph 8502(*k*) of the Regulations requires that property held in connection with one benefit provision of an RPP not be made available to pay benefits under another benefit provision of the same plan. The paragraph exempts from this restriction a transfer of property from one provision of a plan to another where the transfer would be in accordance with any of subsections 147.3(1) to (4.1), (6) and (8) of the Act if the two provisions were in separate RPPs.

Paragraph 8502(*k*) is amended to add to the list of exempted transfers an intra-plan transfer that would be in accordance with new subsection 147.3(7.1) of the Act. That subsection permits the transfer of surplus from one money purchase plan to another, where the second plan replaces all or part of the first plan.

This amendment, which is consequential to the introduction of subsection 147.3(7.1) of the Act, applies to transactions that occur after 1998.